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## **The Streamlined Sales and Use Tax Agreement: A California Perspective**

*By Martha Jones, Ph.D.*

*Requested by Senator Dede Alpert  
And Senator Debra Bowen*

**February 2005**

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# **The Streamlined Sales and Use Tax Agreement: A California Perspective**

*By Martha Jones, Ph.D.*

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“The use tax remains the weak link in state sales tax administration, though total revenue loss is probably not great.”

--- John F. Due and John L. Mikesell, *Sales Taxation*, 1994, p. 275.

“This isn’t about ‘taxing the Internet.’ It’s about fairness, because people should be taxed on what they buy, not on how they buy it. There’s no reason why you should have to pay sales taxes when you buy something at the mall, while your neighbor who shops from a catalog or over the Internet from the comfort of her living room can buy the exact same thing without having to pay the same taxes.”

--- State Senator Debra Bowen, *Sacramento Bee*, October 11, 2003

“They are not interested in tax equity. They are interested in more revenue.”

--- Jonathan Coupal, President of the Howard Jarvis Taxpayers Association, *Sacramento Bee*, October 11, 2003

“Republicans and some Democrats oppose raising taxes, but [Governor Davis] and I agree that collecting taxes that are already owed is the right thing to do. Buying from catalogs or over the Internet has never been tax-free. This bill will make it easier for Californians to do the right thing and pay the taxes they owe.”

--- State Senator Dede Alpert, Press Release, October 10, 2003

“It seems inevitable that there will be more regulation coming to the Internet. It’s only a matter of time before e-commerce will be taxed with more predictability.”

--- Kate Delhagen, Forrester Research, *CFO Magazine*, February 2004.

“On the books since 1935, the California use tax is one of the least enforced and silliest of all taxes. It is a tax on consumers who use things.”

--- Bill Leonard, California Board of Equalization Member, *The Leonard Letter*, April 21, 2003.

“It is hardly worth remarking that appellant’s expressions of consternation and alarm at the burden which the mechanics of compliance with use tax obligations would place upon it and others similarly situated should not give use pause. The burden is no greater than that placed upon local retailers by comparable sales tax obligations; and the Court’s response that these administrative and record keeping requirements could ‘entangle’ appellant’s interstate business in a welter of complicated obligations vastly underestimates the skill of contemporary man and his machines.”

--- Justice Abe Fortas, in his dissenting opinion, *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, May 8, 1967.

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The opinions and analysis in this paper are those of the author and do not reflect the views of California Board of Equalization staff or the Streamlined Sales Tax Project.

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## EXECUTIVE SUMMARY

A general sales tax is currently imposed by 45 states plus the District of Columbia. In fiscal 2003, sales taxes returned to their position as the largest single source of state tax revenue. Despite their importance to states' tax structures and despite the rise in rates over the past decade, sales taxes as a proportion of total state revenues have been flat since 1990. Generally, state sales tax systems have not been updated to keep pace with changes in the modern economy. Designed in the 1930s, sales tax bases were largely limited to tangible personal property. Today, economies are increasingly dominated by untaxed services and intangibles, which are in many cases not subject to sales tax. States have also chosen to exempt much tangible personal property from their tax bases. In addition, the growth of remote commerce (via catalog, telephone and the Internet) has created numerous opportunities to avoid paying or collecting tax on taxable transactions.

Efforts to comply with state sales and use taxes are complicated by administrative burdens due to the lack of uniformity among the states regarding definitions of taxable items, determination of the sale location, and many other administrative requirements. Additional complexities arise from the administration of sales and use taxes by numerous local governments. There are currently more than 7,500 sales tax jurisdictions across the United States. With the purpose of modernizing sales tax systems and in response to a U.S. Supreme Court decision that bars individual states from requiring remote retailers to collect state sales taxes, states created a coalition committed to simplifying and improving sales tax administration. The effort that has gained the most momentum is the Streamlined Sales Tax Project (SSTP), which is attempting to develop a standardized sales tax system.

By November 2002, 38 states were voting participants in the SSTP process and 30 states (plus the District of Columbia) ratified the Streamlined Sales and Use Tax Agreement (SSUTA or the "Agreement"), but had not necessarily adopted their sales tax systems to conform to the Agreement's requirements. California and New York were among a handful of states that had not joined the effort. The states most involved in the SSUTA tended to be smaller and/or highly reliant on sales tax revenues. Two of the large states that ratified the Agreement, Texas and Florida, do not have an income tax and depend heavily on sales tax revenue. Illinois also ratified the SSUTA, but only after insisting on modifications of at least one key portion of the Agreement.

In 2000, Governor Gray Davis vetoed legislation that would have allowed California to actively participate in the SSTP. During 2002 and early 2003, the California Commission on Tax Policy in the New Economy held hearings concerning the SSTP and California's lack of participation in the effort. Many speakers, but not all, felt that California should be actively participating in the process. Some of the reasons for participating were:

1. The current sales and use tax system is in need of reform. It is increasingly complex and a burden on multi-state business.

2. States need to create a level playing field among businesses that charge sales tax (those with a physical presence in the state, or “nexus”) and that do not. It’s an issue of tax fairness to Main Street (i.e. brick-and-mortar) businesses.
3. The structure of the sales tax needs to reflect the structure of the new economy. Moreover, increased remote sales are causing a loss of revenue. Estimates for these revenue losses vary widely.
4. California should participate in the SSTP effort so that the Agreement will be on terms favorable to the state. Since the SSTP is the multi-state effort that almost all states with sales taxes are working on, California should be at the table.
5. Other solutions to the problem of the non-collection of use tax on remote sales have not worked well.

Arguments against California’s participation in the SSTP ranged from theoretical criticism of the Agreement itself, to disagreement about the extent to which the SSTP would result in increased revenues, to practical considerations about how the Agreement would affect sales and use tax collection in California. As it has evolved, the Agreement is clearly not as “streamlined” and simplified as originally intended, and skeptics worried that the costs of participation to California would not be worth the benefits. The Agreement is also not as comprehensive as many would have liked. It does not cover, or even define, services, for example.

On October 8, 2003, Governor Davis approved legislation that enabled California to join the SSTP effort as a voting participant.\* The California legislation creates a Board of Governance to represent the state in all meetings concerning the new tax system. The Board is authorized to vote on behalf of California and to represent the state in all matters pertaining to the Agreement. The Board of Governance is to report to the California legislature quarterly on progress in negotiating the Agreement. **Now that California is a voting participant, the next step will be for California to decide whether to conform its sales and use tax laws to those of the Agreement. California will also have a voice in the final shape of the Agreement, which is still under discussion and modification.**

The current target date for implementation of the Agreement is October 2005. Once a state has amended its statutes to conform to the terms of the Agreement, the state is to send a petition to the Streamlined Sales Tax Implementing States (SSTIS) with proof of compliance. As of November 2004, 41 states, including California, were members of the SSTIS. Nineteen states had enacted substantial compliance legislation and made up the Conforming States Committee of the SSTIS. When a sufficient number of states are found to be in compliance with the Agreement, the SSTIS will dissolve, the interstate Agreement will become effective, and a permanent Governing Board will be established.

**Preliminary analysis by the California Board of Equalization indicates that conforming would require a major overhaul of the state’s sales and use tax system. Sales throughout the state would be affected, not just sales made over the Internet.** This report describes major provisions of the SSUTA Agreement and preliminary

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\* SB157, author: Senator Bowen. This legislation became effective January 1, 2004.

estimates of the impact of joining the Agreement on the California sales and use tax system. California law already conforms to several major provisions of the Agreement, but would require major revisions to conform to most of the Agreement's provisions.\*

Examples of changes to California's laws, regulations and databases that would be required are:

- Under the Agreement, California would still be able to choose which goods to tax or not tax, but it would not be able to deviate from the Agreement's definitions of categories of goods. For example, currently California law generally applies sales tax to carbonated beverages (soda) but does not apply sales tax to non-carbonated beverages such as fruit or vegetable juices. Under the Agreement, this would not be possible: sodas would be defined under "soft drinks" with most non-carbonated beverages. If California chooses to continue to tax sodas under the "soft drink" definition, it would have to tax non-carbonated beverages that are currently exempt from tax. Or California could exempt all "soft drinks," including sodas.
- For most transactions, California currently imposes the sales tax at the origin of sale (the location of the seller). The Agreement requires destination-based sourcing, which means sales tax revenue generally goes to the location where the purchaser receives the item sold. Retailers who ship or deliver sold items to their customers' locations are required under the SSUTA to collect the local sales tax in effect where the delivery is made. The Agreement's sourcing rules would result in a reallocation of California's local sales tax revenues.
- Numerous new systems and databases would be required. For example, the state would have to provide and maintain a database of sales and use tax rates for all taxing jurisdictions and a taxability matrix, showing whether specific goods are taxable or exempt. The taxability matrix will list the defined terms in the Agreement and then whether a state taxes or exempts the defined term.
- The SSUTA governance rules would give only one vote to California, which would shift some aspects of control of the state's sales tax out of the hands of the legislature and the State Board of Equalization to the SSUTA.
- California would have to put in place provisions to compensate certain vendors (for example, retail stores) for sales and use tax collection, which the state currently does not do. Under the SSUTA system, there is no requirement for compensation unless one of the technology models is used or the vendor has voluntarily registered with the SSUTA.

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\* California law currently complies with the following SSUTA provisions: State Administration of State and Local Sales and Use Taxes, Notification of Rate Changes, Reduction of Multiple Tax Rates, Direct Pay Permits, Rounding Rule, Customer Refund Procedures, Audit Procedures, and Confidentiality and Privacy Protections. Other SSUTA provisions would require extensive amendments of California law: Taxing Authority Preserved, Single Tax Base, Seller Registration, Uniform Sourcing Rule, Exemptions, Uniform Tax Returns, Uniform Rules for Remittances, Bad Debt Recovery, Caps and Thresholds, Uniform Definitions of Goods and Services, Registration and Amnesty, Vendor Compensation and Technology Models for Remittance, Relief of Liability, Taxability Matrix, and Governance.

- The Agreement's amnesty provisions are different from, and more generous than, current California law.
- By 12-31-05, no partial sales tax exemptions would be allowed, except for transfers of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, mobile homes or items where the burden of administration has been shifted from the retailer.\* In California, examples of goods currently partially exempt from the state general fund portion of the sales tax rate (5.25 percent) are farm equipment and machinery, timber harvesting equipment and machinery, and racehorse breeding stock.

**For each state, moving towards compliance with the SSUTA can be thought of as a two-step process: First, sales and use tax laws need to be changed to conform with SSUTA definitions, rules and regulations. Second, using the SSUTA definitions, each state legislature decides whether a category of items is taxed or not.** States cannot not deviate from the SSUTA's definitions, but they have many choices as to how to comply. There is nothing in the Agreement itself that dictates whether, at the end of the process, the tax base will increase or decrease. The fiscal impact of the SSUTA depends largely on legislative choices. Complying with SSUTA definitions could result in some products currently not subject to sales tax to become taxable, and also some products that are taxable to no longer be taxed. If the net result is an expansion of the tax base, the legislature could lower the sales tax rate to make the changes revenue neutral.

**Even if states were to conform their laws to the SSUTA, the system is still voluntary for businesses.** The use tax is not a new tax – in most cases, it is already owed, but the SSUTA system will change who collects and pays it. Compliance with the SSUTA wouldn't increase the tax imposed; it just allows collection by a seller rather than remittance by the customer. Currently, in cases where consumers owe use tax, they usually do not remit the tax. The courts have argued that requiring businesses to remit this tax for consumers would be too costly and cumbersome. Under the SSUTA, procedures for remitting use taxes by businesses are designed to become streamlined and less cumbersome. States hope that businesses will voluntarily register with the SSUTA and remit the use taxes that are already due. The SSUTA system, however, will not become mandatory, including collection from Internet and catalog sales, until Congress overturns or the Supreme Court overrides the Court's decision forbidding sales or use tax collection from remote sellers. **It is not obvious that California or any state would get significant additional sales tax revenue without an act of Congress and it is by no means clear that Congress is anxious to authorize sales tax collection on interstate and Internet transactions.** Two bipartisan bills have been introduced in Congress (HR 3184, S 1736) to deal with the streamlined sales tax issue.

Over time, the business community has become split on support for the streamlining process. On the one hand, large, established retailers tend to favor the SSUTA. They

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\* As a result of removing partial exemptions, a state has to choose to entirely exempt the item or entirely tax it. If a state chooses to tax what had previously qualified for a partial exemption, it could keep the status quo fiscally by allowing the purchaser to claim a refund. A refund process would burden the purchaser and the state administratively.

already collect sales/use tax because they have nexus in most states. One pure e-tailer, Amazon.com, has been involved in the SSTP from the beginning and appears to be supportive of the project. On the other hand, smaller, specialty retailers are more likely to oppose the SSTP. Some retailers have structured their online operations as separate legal entities in order to avoid paying California sales and use tax: an example is BarnesandNoble.com. **In general, however, the trend seems to be for more online businesses to voluntarily collect sales/use tax, regardless of the streamlining effort, as businesses adopt an increasingly popular business model that integrates physical store locations with Internet sales.** Customers want a 'consistent shopping experience:' they want to be able to purchase goods online and then return/exchange the items at local brick-and-mortar stores. The acceptance of returns or exchanges, however, creates sufficient nexus between the remote seller and the state to allow the state to compel tax collection by the remote seller.\* According to Forrester Research, these multi-channel retailers constituted 75 percent of total on-line sales in 2003, up from 67 percent in 2001.<sup>1</sup>

Rapid growth in e-commerce in the past five years has caused concern among state and local governments. Census data show, however, that while retail e-commerce receipts have grown rapidly, they have to a large degree been replacing other types of remote sales (for example, mail order catalog). Growth in total retail remote sales has been much slower. In addition, the vast majority of e-commerce transactions are not taxable because California taxes only *retail sales of tangible personal property*. California does not tax the sale of most services or intangible goods. It also does not tax business transactions in which goods are sold for the purpose of resale. According to 2002 figures from the U.S. Census Bureau, only four percent of e-commerce is retail trade. Most business-to-business (B-to-B) e-commerce is handled by the Electronic Data Interchange (EDI) system over a network of mainframe computers. Wholesale transactions on EDI constitute the vast majority of B-to-B e-commerce transactions, although there are many B-to-B transactions where the business purchaser is the consumer of property used in its business.

If state and local governments were able to tax remote sales, how much revenue would they gain? Recent studies have focused on the e-commerce portion of remote sales and **revenue loss estimates due to e-commerce sales vary widely**. A 2004 national study with individual state estimates done by Professors Donald Bruce and William Fox at the University of Tennessee produced estimated revenue losses for the nation of between \$15.5 and \$16.1 billion in 2003, and for California of \$2.1 to \$2.2 billion. Loss estimates by the Direct Marketing Association for the entire nation were only \$2.5 billion in 2003. California's share of these losses would be on the order of \$350 million. As these losses are projected forward in time, the difference between the DMA and the Tennessee estimates becomes even more pronounced. In many respects, these studies use a similar methodology, but assumptions differ, especially concerning B-to-B e-commerce. Unlike the Bruce/Fox study, the DMA excludes most transactions occurring over the EDI network from the loss calculations because it assumes these transactions are wholesale in nature and not taxable. For B-to-B transactions that are taxable, the DMA also assumes a

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\* Annotations, Business Taxes Law Guides: 220.0002 Accepting Returned Products on Behalf of Out-of-State Retailer. 6/22/99. (2000-1).

high use tax compliance rate, arguing that these companies are subject to audit. As a result, a substantially smaller percentage of B-to-B transactions result in revenue loss in the DMA study.

**In 2003, losses to California state and local governments from all remote sales as estimated by the Board of Equalization (BOE) were \$1.345 billion. This represented losses of \$282 million in mail order, \$208 million in B-to-C e-commerce, and \$855 million in B-to-B e-commerce.** This report compares the BOE methodology with that of other studies and shows the BOE estimates to be fairly conservative, but solidly between the high and low estimates from other studies.

Further research is necessary to estimate the effects of California modifying its sales and use tax laws to comply with the SSUTA. The BOE is currently undertaking a detailed review of the effect that conforming to the SSUTA would have on California's sales and use tax system.

The legislature may want to request the following estimates from the BOE:

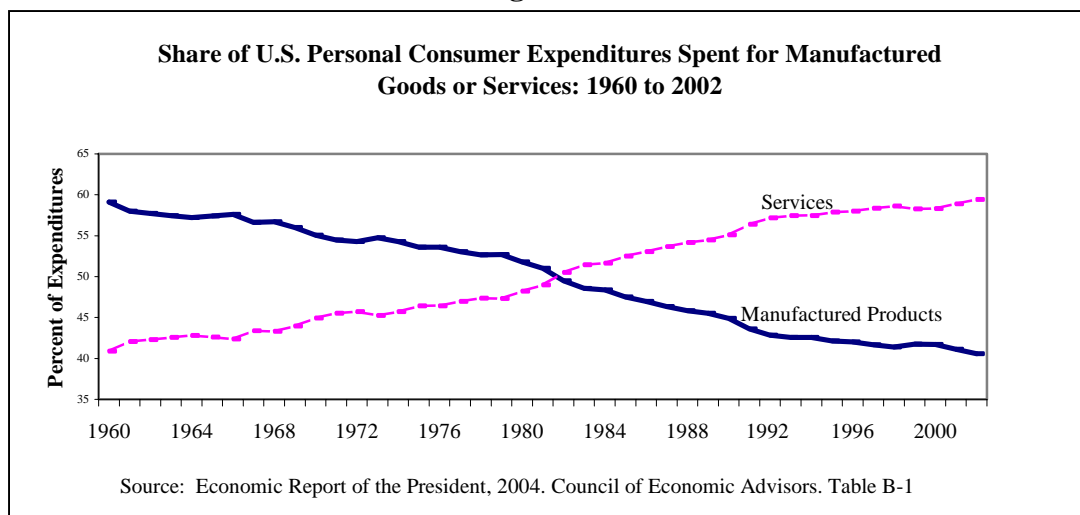
1. The annual amount of use tax collected from the out-of-state sales line on the personal income tax form. The BOE projected that this line would raise \$13 million in 2003, but the state had collected only about \$2 million as of October 2004.<sup>2</sup>
2. An annual estimate of California revenue losses from remote sales. These losses were estimated by the BOE at \$1.239 billion (2001) and \$1.345 billion (2003).
3. A current estimate of the percentage of California's business-to-consumer remote sales that are from firms with California nexus. The most recent estimate (50 percent) is from a 1985 BOE study for mail order sales. This percentage is used in the calculation of revenue losses from remote sales.
4. Estimates of the revenue gain/loss to the state of California from conforming to specific SSUTA provisions:
  - a. Cost of introducing vendor compensation.
  - b. Effect of introducing an expanded sales-and-use-tax amnesty program.
  - c. Distributional impact across California cities and other taxing jurisdictions of changing sourcing from the current origin-based system to the SSUTA's destination-based system. An estimate of the value of sales currently delivered or shipped to an address within the state would be part of the larger distributional impact calculation.
  - d. The BOE should identify items where compliance with SSUTA definitions would result in changes in the taxability status of items. Legislative choices concerning changes in taxability status should be clearly identified. The implications with respect to sales tax revenue should also be calculated.

## SALES AND USE TAX (SUT) INTRODUCTION

The sales tax is an important component in the tax systems of most states. More than 7,500 state and local taxing jurisdictions, including 45 states and the District of Columbia, levy a sales tax on most tangible retail sales. Nationally, sales and use taxes generate over one-third of total state and local government revenue. In fiscal 2003, general sales taxes returned to their position as the largest single source of state tax revenue, yielding \$189.02 billion, compared with \$181.93 billion from individual income taxes. Sales taxes had been the largest source from fiscal 1947 through 1997, when they were overtaken by individual income taxes. For fiscal 2003, 23 states collected more from the income tax than from the sales tax.<sup>3</sup> In California, the sales tax is the second largest state revenue source and is assessed at both the state and local levels. In 2002-03, California sales tax revenues totaled about \$35.7 billion, with \$22.6 billion going to the state's General Fund and \$13.1 billion to local governments.<sup>4</sup>

The California sales tax is a tax on final sales of tangible personal property, such as clothing, household furnishings, appliances and motor vehicles. Sales of goods for resale are not taxed and certain individual items are specifically exempted. The largest of these exemptions (also called tax expenditure programs) involve utilities and home-consumed foods. Compared with other states, California taxes only a few services. In its 1996 survey of sales taxation of services, the Federation of Tax Administrators found that California taxed only 13 of the 164 services surveyed. Other large states taxed more: Texas (78), New York (74), and Florida (64).<sup>5</sup>

**Figure 1**



Over the past 40 years, there has been a fundamental shift in how consumers spend their money away from manufactured products and towards services, which are in many cases not subject to sales tax. In 1960, U.S. consumers devoted about 60 percent of income to manufactured goods and 40 percent to services (see Figure 1). By the early 1980s, services and manufactured goods had reversed their standings and in 2002 consumers devoted 60 percent of their spending to services.<sup>6</sup> As the U.S. population ages over the

coming decades, consumer expenditure patterns are likely to continue to change, resulting in a further increase in the consumption of goods that are largely untaxed such as general services, medical services, prescription drugs, and medical products. A shift from taxable to untaxed consumption items could have important sales tax revenue implications for the states in the future.<sup>7</sup>

What is commonly termed “the sales tax” includes both sales and use taxes (SUT). Sales taxes apply to retail transactions that occur within a state, while use taxes must be paid by buyers who use, consume or store in-state items that were purchased out of state. States require sellers to collect and remit sales tax levied on taxable sales transacted within an individual state’s borders. If products are shipped outside the state, the seller is not required to collect sales tax, but purchasers are supposed to pay the use tax where the product is stored, used or consumed. A seller making a sale in another state is required to collect the use tax on behalf of the buyer if that seller has “nexus” in that state. Although generally referred to as a “sales tax” because it is on the retail transaction, technically, it is a “use tax.”

The sales tax and use tax are generally imposed at the same rate and on the same items. However, they differ in their allocation at the local level. Regulation 1802 states that local sales tax is allocated to the place where the sale is deemed to take place. Local use tax collected by out-of-state retailers is allocated to the use tax pool in the county in which a purchaser resides. Money in each county pool is allocated on a quarterly basis to all jurisdictions in the county on a pro rate basis, based on that jurisdiction's share of non-pooled sales and use tax in that county.

The bulk of SUT revenues are earned from the sales tax levied on in-state transactions. Use tax remittances generally are not paid by individual purchasers, except on transactions involving products that must be registered with the state, such as a car or a boat. If a California resident buys a car in Nevada, for example, he or she must pay the use tax on the purchase price when registering the vehicle in California. For goods that are not registered, the state does not collect use tax unless it is voluntarily remitted by the purchaser, voluntarily collected and remitted by the remote seller, or collected and remitted by an out-of-state seller with nexus.\* Historically, voluntary compliance with the use tax by individuals or by remote sellers has been rare.

Attempts by various states to require remote sellers with no physical presence to collect and remit use tax on merchandise sold to a state’s residents have been restricted by U.S. Supreme Court decisions. In 1967, the Court ruled that collecting use tax on remote sales would place an unconstitutional burden on businesses lacking a physical presence in the state because of the complexity of the tax system.<sup>†</sup> In 1992, states were again denied the power to enforce collection of the use tax from sellers, unless Congress decides to give them the power to do so.<sup>‡</sup> Until recently, most remote transactions were from mail order (catalog) sales. Although states lost revenue due to their inability to collect use tax, the

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\* A remote seller refers to an out-of-state seller without nexus making sales in a state.

<sup>†</sup> U.S. Supreme Court, *National Bellas Hess, Inc. v. Illinois* (386 U.S. 753, 1967).

<sup>‡</sup> U.S. Supreme Court, *Quill vs. North Dakota* (504 U.S. 298, 1992).

amounts were small and were not critical to state budgets. The growth of Internet transactions, coupled with an economic shift from production of goods towards services, has many states worried about future sales tax revenues. Internet transactions have grown rapidly in the past few years, but to a large extent they have been replacing catalog sales. Total remote sales are projected to grow in the near future, but estimates vary as to how quickly. As remote sales grow, the percentage of transactions subject to the sales tax (and mandatory tax collection) decreases, while the percentage of transactions subject to the use tax (dependent on voluntary remittance) increases.

The states are not alone in their concerns: brick-and-mortar businesses are also clamoring for a level playing field. While the Main Street or shopping mall seller with a physical presence in the state must collect sales tax on transactions, an Internet business with no physical presence in a state does not have to collect sales tax, and many do not. Despite shipping costs, the Internet seller gains a price advantage because customers generally do not voluntarily remit the use tax. In fact, most consumers are unaware of this obligation. The phrase “bricks vs. clicks” describes the tension between “Main Street” merchants and Internet businesses.

In 1998, Congress passed the Internet Tax Freedom Act (ITFA), which established a three-year moratorium on the levying of state taxes on Internet access and of multiple taxes on Internet transactions. Contrary to popular belief, the ITFA does not prohibit states from attempting to collect sales and use taxes on Internet purchases. The moratorium was reportedly adopted to encourage the development and accessibility of the Internet and Internet-related businesses, and was extended through November 2003. Members of Congress then introduced legislation to further extend the moratorium, either temporarily or permanently. In 2003, members of the House of Representatives passed HR 49, known as the *Internet Tax Non-discrimination Act*, to permanently extend the ITFA moratorium. In the Senate, S 150 was passed in late April 2004 and would restore a moratorium on taxing Internet services for four more years. The Senate bill expands coverage from the federal moratorium that expired in November to include high-speed, or broadband, access and does not apply to sales taxes on goods purchased online.<sup>8</sup> In November 2004, a compromise was reached between the houses that would extend the ban on all Internet access and service provider taxes until November 1, 2007. States already taxing dial-up service would continue to be grandfathered in.<sup>9</sup>

Federal intervention will be required to address the problem of remote sales taxation. The U.S. Supreme Court has stated that, while states cannot begin to tax remote sales on their own, Congress has the power to legislate a nationwide solution because it has the authority to regulate interstate commerce. To date, Congress has not done so. In September 2003, bipartisan bills seeking to give states power to collect taxes on remote sales were introduced by U.S. Representatives Ernest Istook (R-OK) and William Delahunt (D-MA) and U.S. Senators Michael Enzi (R-WY) and Byron Dorgan (D-ND) in their respective chambers (HR 3184, S 1736).<sup>\*</sup> The measures, which are called the *Simplified Sales and Use Tax Act*, did not make it out of committee. Senator Enzi has

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<sup>\*</sup> The link to October 1, 2003 testimony before the House subcommittee that reviewed HR 3184 is: <http://judiciary.house.gov/schedule.aspx>.

said that to convince Congress, states must stress that, “we are not going to raise anybody’s taxes.” States should also emphasize that if they are not allowed to fix their sales tax systems, they will be coming to Congress for help if an antiquated system leads to a lack of funding for essential services, such as public safety and education.<sup>10</sup>

A key impediment to a solution is the complexity of the 7,500 state and local sales tax jurisdictions. Another is Congress’ unwillingness to “expand” taxation. Proponents of the streamlined sales tax approach argue that if sales and use tax systems can be simplified so that remote sellers do not view collection of the use tax as a burden, businesses might cooperate with the states and start collecting the use tax. In turn, Congress might look more favorably on taxation of remote sales.

Following this reasoning, several multi-state organizations\* and state revenue officials, in cooperation with business leaders, began in 2000 to encourage states to develop and implement a uniform agreement. There are a number of multi-state compacts that establish uniform laws and procedures, without the need for Federal legislation. The U.S. Supreme Court has recognized the validity of agreements to streamline and simplify the administration of sales and use taxes. Several parallel efforts were undertaken, but the Streamlined Sales Tax Project emerged as the effort backed by the major groups. The Streamlined Sales and Use Tax Agreement (SSUTA) was ratified by 30 states and the District of Columbia in November 2002.<sup>11</sup> Participating states have begun implementing legislation to conform their laws to the Agreement but opposition to the taxation of remote sales remains strong from e-commerce businesses as well as from those philosophically opposed, on the grounds that efforts to collect use tax amounts to new or additional taxation. Other proposals, such as a national sales tax or value-added tax, have also been discussed.

Due to the increasingly heated debate over expanded Internet sales taxes, e-commerce merchants are no longer “one big, happy family.”<sup>12</sup> Most large retailers already have locations in almost all the states and must collect sales tax. Staples Inc., for example, is pressing for federal legislation to end what it considers an unfair system in which pure Internet retailers (those without nexus) have an edge. In testimony to the U.S. House Judiciary Committee urging adoption of the Simplified Sales and Use Tax Act of 2003 (J.R. 3184), a Staples executive testified that Internet retailers currently enjoy the benefits of public services without the burden of collecting taxes to pay for them.<sup>†</sup> The National Association of Counties pointed out that the bill would help them raise revenue in ways other than taxing property.<sup>13</sup> In addition to cash-strapped state governments, the following businesses and organizations have been lobbying for federal legislation allowing states to collect sales taxes on goods from retailers with no physical presence or nexus (no stores or warehouses in the state):

- The National Retail Federation and the Jewelers of America.<sup>14</sup>

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\* The National Conference of State Legislators (NCSL), the National Governors Association (NGA), the Multistate Tax Commission (MTC), the Federation of Tax Administrators (FTA).

† An irony of this story is that Staples now owns the Quill Corporation.

- Many of the largest retailers and online merchants in the country, for example, Staples Inc., Target, WalMart and Sears.<sup>15</sup>
- International Assn. of Fire Fighters, an AFL-CIO member, lobbied Capitol Hill for the first time on March 15, 2004 for online sales taxation, arguing that lost revenue due to uncollected remote sales tax deprives firefighters of government funding.<sup>16</sup>

For merchants that conduct all or most sales online, on the other hand, the SSUTA is seen as creating new burdens that will chill the growth of e-commerce. Smaller businesses have voiced concerns about the cost on business of complying with the Agreement. The Direct Marketing Association maintains that foreign companies would be favored if the SSUTA were implemented. Examples of business concerns with the SSUTA are:<sup>17</sup>

- States might attempt to use sales tax simplification legislation to expand the tax base.
- States might shift complexity to other taxes (i.e. attempt to move existing sales and use tax provisions that do not comply with the SSUTA into other areas of the tax code.)
- The technological solutions proposed under the Agreement might not be as readily available and cost-effective as claimed by SSUTA proponents. Using technology to pinpoint a single sales tax rate per zip-code-plus-four might be possible, but determining taxability (which goods are taxed) at each location is more difficult. The U.S. Post Office designs zip code boundaries as postal routes and not as tax jurisdictions. Overlapping jurisdictions and frequent changes in zip code boundaries are examples of complications with the SSUTA.
- Federal legislation on *Quill* may affect nexus determination by states for other types of taxes (i.e. business activity taxes, including income and franchise taxes). A bill (HR 3220) to set up a “bright-line” test for state business activity tax nexus had a House Judiciary subcommittee hearing last session before it died.\* Congressional legislation in the sales tax arena may become linked to an attempt to codify a physical presence nexus standard for business activity taxes. According to the Delaware *State News*, this prospect has the governor of Delaware, a state without a sales tax, concerned. If Congress were to impose restrictions on taxing corporations that lack physical nexus, and as a result, Delaware could not tax corporations without a physical presence in the state, Delaware could lose \$20 million.<sup>18</sup>
- Business groups represented by the Council on State Taxation (COST) have pointed out a possible conflict of interest if the Multistate Tax Commission, a government organization with audit powers over multistate businesses, gathers businesses’ financial information during the SSUTA registration process. COST representatives have warned that MTC involvement in running the SSUTA electronic registration system could undercut potential business participation in the Agreement.
- Businesses are concerned about the level of oversight the SSTP’s governing board would have in the decisions and membership of the Business and Taxpayers Advisory Council. This Council will be established to advise the governing board.<sup>19</sup>

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\* Testimony: May 23, 2004 hearing: <http://judiciary.house.gov/media/pdfs/printers/108th/93657.PDF>.



## STREAMLINED SALES TAX PROJECT: THE BASICS

The Streamlined Sales Tax Project targets the problematic complexity of diverse state administrative tax code structure by bringing a broad coalition of players to the table and bundling policy reform with new technology solutions (such as Internet-based tax collection software). Sales tax complexity has two principal components:

1. State and local sales tax laws with more than 7,500 jurisdictions date back to the 1930s. Increasingly they impede a borderless national economy. Furthermore, as the economy has tilted toward services, which are largely untaxed, state tax bases have been narrowed. This base erosion will accelerate as online buying increases.
2. In a 1992 decision, *Quill vs. North Dakota*, the Supreme Court ruled that it was an undue burden on interstate commerce for individual states to require remote sellers to collect taxes, maintain records and remit taxes to multiple jurisdictions.\* The decision left open the possibility that Congress could authorize collection of use taxes on remote sales. If the states simplify the sales tax system and Congress fails to act, the states could also go back through the court system to show that collection requirements no longer impose an undue burden on sellers. The *Quill* decision is summarized in Appendix N.

The SSTP effort attempts to address this challenge by:

1. Crafting model uniform legislation to be adopted by each state that would modernize sales tax systems by simplifying state and local sales and use tax codes and administrative processes uniformly across the U.S.
2. Reducing the collection burden placed on remote sellers sufficiently to convince Congress and/or the Supreme Court not to preempt state authority to require remote sellers to collect and remit use taxes to states on the same basis as brick-and-mortar stores.

A history of the National Conference of State Legislators task force that, in 1999, established a set of principles that led to the drafting of model legislation for the SSTP is available online at: <http://www.ncsl.org/programs/fiscal/history.htm>.

## SSUTA PROVISIONS

The goal of the Agreement is to provide states with a streamlined, standardized sales tax system. California already follows some of the major provisions including:

- **Rate simplification.** States are allowed one uniform state rate, and a second statewide rate in limited circumstances. For example, a few states such as Illinois have a second, reduced state rate for food and drugs. Local jurisdictions are allowed only one local rate per jurisdiction.

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\* U.S. Supreme Court, *Quill vs. North Dakota* (504 U.S. 298, 1992).

- **States are responsible for administering all state and local taxes as well as distributing local taxes to local governments.**<sup>\*</sup> A state and its local governments use common tax bases.<sup>†</sup> Exceptions are provided for motor vehicles, aircraft, trailers, semi-trailers, watercraft, modular homes, manufactured homes and mobile homes.<sup>20</sup>

Conforming to many of the SSUTA provisions would require changes in California law:

- **Uniform definitions within tax laws.** Legislatures choose what goods and services are taxable or exempt in their states. However, participating states agree to use common definitions for key items in the tax base. Conforming to the SSUTA definitions would require numerous changes to California law.
- **Uniform sourcing rules for transactions.** The Agreement contains destination-based rules for sourcing retail sales: if a product is received by the purchaser at the seller's business location, the sale is "sourced" to that location, which means the tax rate at the seller's business location is used and the revenue goes to that jurisdiction. If the product is shipped and received at another location, the sale is sourced to the location of receipt of the good. For most local tax transactions, California currently uses an origin-based system, which means sales are sourced to the seller's business location, even sales that are shipped elsewhere within the state.
- **Simplified administration for exemptions.** The Agreement provides for uniform standards for the administration of exemptions, including a standard electronic exemption form. Sellers following the Agreement's exemption requirements are relieved of liability when the purchaser improperly claims an exemption (thus, no "good-faith" standard is applied).

In addition, key SSUTA provisions would require states to:

- Provide for an online, one-stop registration system for sellers who volunteer to participate.
- Provide sellers as much advance notice of state rate and boundary changes as possible. Local rate and boundary changes can only take place at the start of a calendar quarter with at least 60 days notice, and 120 days for catalog notices.
- Offer retailers a uniform sales tax form.
- Provide amnesty to sellers that register under the Agreement (within 12 months of a state's participation) for uncollected or unpaid sales or use tax (plus penalty or interest) for sales made during the period the seller was not registered in the state.
- Have uniform audit procedures.

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<sup>\*</sup> The Agreement states that administration must be at the state level but that administration may be done by a person other than the state as long as provided for by state law.

<sup>†</sup> An example of potential legislative action that could put California out of compliance with this provision if the state were to join the SSUTA is AB 2546 (Author: Lowenthal, 2004). This bill would authorize local audits for use tax liability.

- Allow participating retailers to use a technology model to collect and remit sales tax revenues to the state. Example of technology models are: (1) a certified service provider performs the seller's sales and use tax functions; (2) a certified automated system calculates the tax imposed by each jurisdiction on a transaction, determines the tax and maintains a record of the transaction; or (3) a proprietary system, in which the seller has entered into a performance agreement with the member states and has total annual sales revenue of at least \$500 million.
- Assume responsibility for funding some of the technology models. This will reduce the financial burden on sellers. States are also participating in a joint business-government study of the impact of collection costs on sellers.
- Submit a "taxability matrix," intended to guide sellers and third-party "certified services providers" in deciding whether to charge tax on selected products (see Appendix G).\*
- Provide monetary allowances (vendor compensation) to certified service providers and certain sellers in the system.

Other issue areas addressed include: privacy policies, uniform rounding rules and uniform rules for bad debts.

## STATE PARTICIPATION IN THE SSTP

There are three levels of state participation in the SSTP effort: public participant, observer, and voting member (see Table 1). Until March 2003, California was a public participant. California had not been sending a representative to actively participate in SSTP meetings, although Board of Equalization (BOE) staff periodically monitored teleconferences and kept generally aware of the group's activities. On March 26, 2003, the BOE voted for California to become an observer state and began sending a BOE staff member to attend SSTP meetings. Although Governor Davis vetoed similar legislation in 2000, in October 2003 he signed legislation committing California to voting status as part of the SSTP group and creating the California Board of Governance (SB 157, author: Senator Debra Bowen). Members of the Board include two Senators, two Assembly members, and representatives from the BOE, the Franchise Tax Board and the Department of Finance.<sup>†</sup> Information on the quarterly meetings of this California Board is available online: <http://www.boe.ca.gov/info/senatebill157.htm>.

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\* The taxability matrix is available at: <http://www.streamlinedsalestax.org/Taxability%20matrixFinal1.pdf>.

<sup>†</sup> "There is created in state government a [California] Board of Governance consisting of two Members of the Senate chosen by the Senate Committee on Rules, one of whom shall belong to the majority party and one of whom shall belong to the minority party, two Members of the Assembly chosen by the Speaker of the Assembly, one of whom shall belong to the majority party and one of whom shall belong to the minority party, one member of the State Board of Equalization, one member of the Franchise Tax Board, and one member of the Governor's Department of Finance." (Revenue and Taxation Code, § 6027 (a)).

**Table 1**

<b>Three Basic Levels of State Participation in the Streamlined Sales Tax Effort</b>		
<b>Level</b>	<b>Conditions</b>	<b>Rights and Responsibilities</b>
Public Participation	<ul style="list-style-type: none"> <li>Project meetings open to the public.</li> </ul>	<ul style="list-style-type: none"> <li>Opportunity to address the project meeting.</li> <li>Cannot attend closed session.</li> <li>Work group committee meetings are not required to be open to the public.</li> </ul>
Observer State	<ul style="list-style-type: none"> <li>Letter from Governor, the presiding officer of a legislative body, or the head of the tax agency.</li> <li>Informed of current work.</li> <li>Cannot commit to working with the other states.</li> </ul>	<ul style="list-style-type: none"> <li>May send representatives to project meetings.</li> <li>May participate in project discussions.</li> <li>Has no right to vote in project meetings.</li> <li>Not eligible to serve as Project Co-Chairs or on Project Steering Committee.</li> <li>May participate and serve in leadership positions within workgroups or subcommittees.</li> </ul>
Voting Participant	<ul style="list-style-type: none"> <li>Requires authorizing legislation or Governor's executive order.</li> </ul>	<ul style="list-style-type: none"> <li>Authority to vote on behalf of the State.</li> <li>Dedicate staff to project.</li> <li>Regular participation in meetings.</li> </ul>
Source: California State Board of Equalization. <i>Informal Issue Paper, SSTP</i> . March 14, 2003.		

Within the voting participant category, there are three levels of increasingly active participation and engagement:

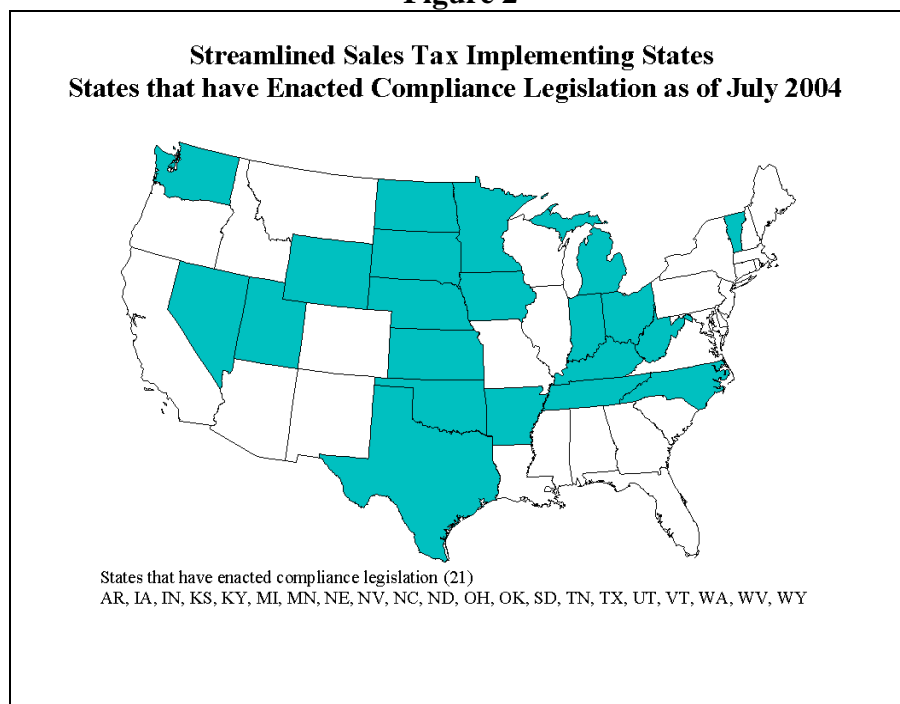
1. SSTP Group – States may adopt enabling legislation, referred to as the Uniform Sales and Use Tax Administration Act (the “Act”). The Act allows the state to enter into an agreement with one or more states to simplify and modernize sales and use tax administration. The Act does not require any specific amendments to a state’s sales and use tax laws.
2. Implementing States (SSTIS) – The SSTIS group is composed of states that have agreed to participate in the streamlining process, but have not necessarily passed conforming legislation. These states became voting participants through legislative enactment of the Act. On November 12, 2002, the Implementing States voted 31-0 (with Maryland abstaining and three states absent) to adopt the SSUTA (the “Agreement”). In 2003, five states (California, Hawaii, New York, Massachusetts and Mississippi) joined the original 35 Implementing States; Georgia joined in 2004.<sup>21</sup>

The 41 states of the Streamlined Sales Tax Implementing States (SSTIS), November 2004
Alabama, Arizona, Arkansas, California, District of Columbia (counted as a state), Florida, Georgia, Hawaii, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

3. Conforming States Committee – Implementing states that pass legislation to *substantially* conform their laws to the SSUTA. With adoption of the Agreement, states amend or modify their sales and use tax laws to achieve simplifications and uniformity. Some states require minor changes, others significant ones. Figure 2 shows the 21 states that enacted legislation as of July 2004 to reform their sales tax administration in accordance with the SSUTA. To date, Michigan is the largest state to enact substantial conforming legislation.\* New Jersey is reportedly the next large population state well on the way to enacting conforming legislation.<sup>22</sup> Appendix A describes legislative efforts in all states. Although Texas and Washington have enacted some compliance legislation, other provisions of the SSUTA have not been enacted, including sourcing.

The 19 States of the Conforming States Committee of the SSTIS: November 2004
Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, North Carolina, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Utah, Vermont, West Virginia and Wyoming

**Figure 2**



Once a state has amended its statutes to conform to the terms of the Agreement, the state is to send a petition to the Co-Chairs of the Streamlined Sales Tax Implementing States with proof of substantial compliance.<sup>†</sup> After the Co-Chairs receive petitions from at least 10 states representing no less than 20 percent of the population of the 45 states with a sales tax and Washington, D.C. [counted as a state in the Agreement], they will convene

\* On 6/28/04, Governor Granholm signed four bills that made up the state's streamlined sales tax initiative: HB5502 (now Public Act 172 of 2004), HB 5503 (P.A. 173), HB 5504 (P.A. 174) and HB 5505 (P.A. 175).

<sup>†</sup> In October 2004, the SSTP Co-Chairs are Diane Hardt (Wisconsin) and Scott Peterson (South Dakota).

a meeting of these initial states. At the initial meeting, each petitioning state will be judged in substantial compliance with the Agreement by a three-fourths vote of the delegates from the other initial states. A certificate of compliance will document each state's substantial compliance.\* Public notice and opportunity for comment will be provided before a state becomes part of the Interstate Agreement. As of January 2004, no state had applied for certification.

When sufficient states are found to be in substantial compliance with the Agreement, the Implementing States organization will dissolve, the interstate Agreement will become effective, and a permanent Governing Board will be established. *The Governing Board will be comprised of a representative from each member state (which is entitled to one vote on the board).* The Governing Board will be responsible for interpretations of the Agreement, amendments and issue resolution. A State and Local Government Advisory Council and a private sector Business and Taxpayer Advisory Council will advise the Board. The ongoing Streamlined Sales Tax Project will also become an advisory body to the Board. The Governing Board is expected to sign contracts with Certified Service Providers (CSPs) to provide technology assistance to sellers and lessors. *The system at that point will still remain voluntary for businesses. It will not become a mandatory system, including collection from Internet and catalog sales, until Congress overturns or the Supreme Court overrides the Court's decision forbidding sales tax collection from remote sellers.*

By letter dated April 7, 2004, the Co-chairs of the Implementing States, Senator Angela Monson and Commissioner Bruce Johnson, named 18 states to the Conforming States Committee of the SSTIS (see box on previous page). The 19<sup>th</sup> state, Michigan, was added to the Committee in Fall 2004. Senator Richard Finan of Ohio and Loren Chumley, Commissioner of the Tennessee Department of Revenue, are co-chairs of this Committee. The purpose of the Conforming States Committee is to “create the administrative mechanisms and staffing necessary to implement the Agreement” and to “lay the groundwork for operational implementation of the Agreement.” On September 7, 2004, Scott Peterson was appointed Interim Executive Director of this committee. Mr. Peterson will be on loan for six to nine months from his job as Director of the South Dakota Department of Revenue's Business Tax Division. He is also SSTP Co-chair.

If a sufficient number of states pass the additional conforming legislation in early 2005, the SSUTA population thresholds could be met on July 1, 2005 and the Agreement could take effect in October 2005.

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\* If a state is found to be out of compliance, it will not be accepted into the Interstate Agreement. It could also be sanctioned or expelled by the other participating states. Sellers who are voluntarily collecting use taxes for participating states could decide to no longer collect for an expelled state. Also, that state would not have a vote on changes in the Agreement.

## Tracking State Participation Levels

State participation levels in the SSTP are tracked on various websites, which each use slightly different methods of describing the level of participation for each state.

- The official website of the Streamlined Sales Tax Project tracks the general level of participation at: <http://www.streamlinedsalestax.org/statestatus.pdf>.
- National Governors Association at: <http://www.nga.org/nga/salestax/1,1169,,00.html>.
- National Conference of State Legislators at: <http://www.ncsl.org/programs/fiscal/stateactionchart2.htm>.  
<http://www.nareit.com>.
- The Equipment Leasing Association at: <http://www.elaonline.com/GovtRelations/State/Streamometer/>.

As of November 2004, 41 states (including the District of Columbia as a state) were entered into the SSTIS and were at various stages of implementing legislation to conform to the Agreement. The following states were not entered into the SSTIS Agreement:

- a. No sales tax – Delaware and New Hampshire,
- b. No sales tax, but legislation introduced to enact a state sales tax that is in compliance with the SSUTA – Montana, Oregon and Alaska,\*
- c. State has sales tax but not participating in the SSTP – Colorado,
- d. SSTIS legislation failed to pass – Idaho and New Mexico (gross-receipts tax), and
- e. Participating states in the SSTP: Pennsylvania and Connecticut

Colorado, which has a complicated state/local sales tax structure with more than 50 different taxing jurisdictions,<sup>23</sup> has been very vocal about not participating in the SSTP effort. At a March 2003 National Governors' Association meeting in Washington, D.C., Colorado's Governor Bill Owens was quoted: "I'm hoping that as other states start to tax the Internet, Colorado can be a tax haven and attract business because of that. I hope that someday, Colorado will be seen as the Switzerland of non-taxation of the Internet."<sup>24</sup> He has said he does not believe state governments will lose a dime from the Internet and he doesn't trust the numbers being cited as to the amount of lost tax revenue from remote sales. He has also stated that people who purchase over the Internet do not use state services when they shop.<sup>25</sup> Governor Owens recently issued a set of nine questions and answers about the SSTP that has been forcefully rebutted by the SSTP group. This discussion is summarized in a later section of this report.

Neither Hawaii nor New Mexico officially regards itself as having a retail sales tax and there are structural differences between their taxes and those levied in other states. Hawaii levies a general excise tax,<sup>†</sup> which is imposed on the business (on gross income). New Mexico relies on a gross-receipts tax structure. Companies based in New Mexico

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\* Montana and Oregon currently have no sales tax; Alaska currently has local sales taxes.

† For more information on Hawaii's excise tax, go to <http://www.state.hi.us/tax/taxfacts/tf96-01.pdf>.

are responsible for collecting gross receipts tax on sales to customers within the state. Before a special legislative session ended November 5, 2003, the New Mexico Senate declined to approve legislation passed by the House of Representatives that would have allowed the state to participate in the Streamlined Sales Tax Project.<sup>26</sup>

### **Moving Towards Compliance with the SSUTA**

For some states, moving towards compliance with the SSUTA has been less complicated than for other states. Efforts to implement destination-based sourcing rules in states that use the origin rule have resulted in the first major backlash against the SSUTA.

*Governing Magazine* has referred to the sourcing problem as the SSTP's first "speed bump" on the road to its new, streamlined sales tax system.<sup>27</sup> Among those states that have not yet conformed their laws to the Agreement, changing to a destination-based system could be a problem in Arizona, California, Illinois, Missouri, Pennsylvania and Virginia.<sup>28</sup> Among states that have passed conforming legislation, even Utah, which had been considered the state the "farthest along" towards certification,<sup>29</sup> has passed legislation to delay sourcing provisions for one year.<sup>30</sup> Washington and Texas did not pass all SSUTA general sourcing provisions in their conforming legislation. Kansas and Ohio have also delayed implementation of their destination-based sourcing laws.

Sourcing is not the only obstacle still facing the Agreement. Among the outstanding unresolved issues are definitions of the "digital equivalent of tangible personal property" and "bundled transactions."<sup>\*</sup> Moreover, a March 2004 meeting in New Orleans hosted by the Council on State Taxation (COST) uncovered several shortcomings in enacted conformity, including failures to adopt all the necessary definitions in the medical area, missing vendor compensation, safe harbors for over-collection, and amnesty.<sup>31</sup> Minnesota, for example did not change the definition of food for immediate consumption to comport with the one agreed to by project members.<sup>32</sup>

Another worry is that the software required to run the system will not be in place by July 1, 2005, the date that the Agreement will be effective in many states. Information about tax rates, jurisdiction boundaries, and taxability has yet to be provided. Some states are reluctant to put things in writing for a variety of reasons; the issue of consumer privacy is still a concern; and differences in state confidentiality laws have not been worked out. It is likely that the multi-state compact will have to follow the requirements of the most restrictive state law. Finally, providing audit personnel for multi-state audits is another area in which states "need to do more work," according to SSTP Co-chair Scott Peterson.<sup>33</sup> Mr. Peterson worries that the technical details necessary for the tax compact

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\* A bundled transaction is the retail sale of two or more products, except real property and services to real property, where (1) the products are otherwise distinct and identifiable, and (2) the products are sold for one non-itemized price. A bundled transaction does not include the sale of any products in which the sales price varies, or is negotiable, based on the selection by the purchaser of the products included in the transaction. The SSTP definition of bundling is still being developed. The SSTP has not defined "services." The most recent bundling definition is available at <http://www.streamlinedsalestax.org/library/Bundled%20Transaction%20Def%209-29-04%20SSTP%20response%201.pdf>.

to take effect won't be ready in time: "I'm beginning to think I'm going to have to stop sleeping if we're going to get it all done. We've got a long way to go."<sup>34</sup>

Many states that enacted conformity legislation during 2003 enacted, or planned to enact, "clean-up" legislation during 2004. An example is Tennessee. On June 15, 2004, Governor Bredesen of Tennessee signed legislation that made 25 revisions and corrections to Tennessee's streamlined sales and use tax law, which was initially enacted in 2003. The measure also set a solid effective date for the SSUTA, July 1, 2005. Within Tennessee, the legislation's biggest impact will be on the distribution of sales tax revenue to local governments due to the change in sourcing from origin-based to destination-based. The sourcing provision takes effect on January 1, 2006, six months after the rest of the legislation.<sup>35</sup>

In 2004, conforming legislation conditional on Congressional action was considered in several states. In Maryland, for example, legislation was signed into law on May 25, 2004 (HB 552) that would bring the state into compliance with the SSUTA Agreement pending action by Congress to grant collection authority. Utah is also considering tying implementation of the Agreement to congressional action. According to Sen. Howard Stephenson, president of the Utah Taxpayers Association, "It's not reasonable to expect businesses to pay significantly higher taxes and for retailers to alter their way of doing business until we know that Congress is going to act."<sup>36</sup> According to industry representatives, the proposed expansion of the definition of "taxable sales" to include freight and installation of equipment on real property in Utah would result in estimated cost increases of \$2 million in the mining industry; \$3 million for a proposed third generating plant at Intermountain Power Agency; and \$100,000 for Questar, a natural gas supplier. Utah State Tax Commissioner Bruce Johnson, co-chair of the SSTIS, has pointed out, however, that tax increases resulting from choices made in streamlining implementing legislation can be handled by legislation outside the streamlining bill; for example, by allowing a tax credit for companies harmed by the freight and equipment installation tax issue. "There is nothing in the SSUTA that precludes us from dealing with those issues."<sup>37</sup>

North Carolina is another example of a state that has already passed conforming legislation but "encountered stumbling blocks" along the way.<sup>38</sup> In April 2003, North Carolina had to either eliminate its two percent local sales tax on food or raise it half a percent to match the rate on nonfood purchases. Some North Carolina legislators would have liked to eliminate the local tax on food completely. Many local leaders, on the other hand, were opposed to eliminating such a large revenue source (\$200 million), and state legislators appeared to be unwilling to find the money to replace this revenue stream. There was no support for raising the local sales tax on food by half a percent.

Indiana also passed new sales tax laws in line with the SSUTA that came into effect on January 1, 2004.<sup>39</sup> These sales tax laws collect revenue from certain delivery and installation charges. Complaints from angry business owners confused about the new tax could lead lawmakers to revoke the assessment. Service providers have been reportedly unable to digest the complexity of the new law. The tax is on installations ranging from

washers and dryers to car stereo systems. For instance, a landscaper's labor charges to plant trees are exempt because the vegetation is considered part of the property. For auto shops, the tax is collected only on the installation of parts considered an upgrade, such as a compact disc player.

In Virginia, a Remote Sales Tax Collection Study Committee recommended that the Virginia General Assembly not consider adoption of the SSUTA in its 2004-05 legislative session. The panel stated, "it is not at all clear that the benefits of SSUTA justify the collection costs and lost opportunity to use tax policy to compete for economic development for Virginia. At this time, there is not compelling reason for Virginia to adopt SSUTA, and there are too many unanswered questions regarding collection costs and ameliorative provisions in SSUTA and proposed federal legislation." In addition, Virginia would have to switch from origin to destination-based sourcing. The panel's report also concluded that little is to be gained by making changes because most Internet sales are either tax-exempt or are already being taxed. That is because most are business-to-business transactions, which are easily audited, or sales to consumers from remote sellers that either voluntarily collect the tax or collect it because they also operate a traditional store in the state.

The Washington Department of Revenue (DOR), on the other hand, has reached the opposite conclusion: According to their analysis, large revenue losses as a result of tax-free sales made by remote sellers will continue to increase at a high rate in future years if a way is not found to have remote sellers collect the tax. The DOR has indicated its intent to make an all-out effort in 2005 for legislative adoption the remaining provisions needed to bring the state's law into conformity with the SSUTA. In early January 2005, DOR Director Will Rice wrote a guest column for the *Seattle Post-Intelligencer* in an effort to explain the benefits of the SSTP to the public and the legislature.<sup>40</sup> "Let's preserve the sales tax by ensuring that it can be simply collected on all sales in Washington. Let's level the playing field for all businesses so they compete on price and quality, not tax advantage. That's the fair thing to do." The two fairness issues he stressed were: Why should merchants on Main Street be required to collect sales taxes while online merchants are not? And why should shoppers armed with a computer and Internet connection be given an easy way to avoid paying sales taxes, unlike those who choose to shop at stores in their community? Director Rice also pointed out that,

- The situation has become so bad, stores have complained that customers come into their showrooms, try out their products, jot down the make and model, and then place an order with online retailers. Stores end up serving as unwitting showrooms for their out-of-state competitors.
- Washington understands the economic potential of electronic commerce and has led the way in consistently opposing the imposition of any new or discriminatory taxes on the Internet. The state also must be a leader in simplifying the collections of taxes that are legally due on Internet and other remote sales.

## **FUNDAMENTAL CHANGES TO CALIFORNIA SALES AND USE TAX LAWS AND REGULATIONS WOULD BE NECESSARY TO COMPLY**

The California Board of Equalization (BOE) has conducted a preliminary analysis of the potential impact of the Agreement on California law. Conforming to the SSUTA would require a major overhaul of both the state's sales and use tax system and the Board's administrative authority. Some changes would be simple, but many others would be far-reaching. This section of the report gives an overview of the magnitude of the changes and then concentrates the discussion on several significant ones. All 81 sections of the Agreement<sup>41</sup> are listed in Appendix B. Some of the effects of compliance on the laws of California as well as the laws of other states are described for 25 of the principal Agreement sections analyzed.

The BOE is currently undertaking a detailed review of each section of the SSUTA and making a comparison to California's Constitution, statutes, regulations, Policy and Procedure Manuals, and other information relating to the administration of sales and use tax. The review of some sections will require significant assistance and input from California's local governments, businesses, and other sources. The analysis will strive to identify the impact of conforming to the SSUTA in the following areas:

- Changes necessary to California's Constitution, statutes, regulations, Policy and Procedure Manuals, etc.
- Tax Revenues, including revenue shifts for local jurisdictions.
- Administrative and operations costs for the state and local governments.
- Compliance and cost issues for businesses.

The analysis for each SSUTA section will be comprised of the following phases. The first sections to be analyzed are the sourcing sections. The time devoted to each phase will differ depending on the complexity of the section being analyzed.

- Complete analysis by BOE staff of the SSUTA section.
- Public comment and review.
- Public comment review by BOE staff.
- Identify impact study options.
- Approval of impact study.
- Complete the impact study.
- Submit the analysis and impact study to the California Board of Governance.

Drafts of the BOE analysis for SSUTA sourcing sections 309 and 310 are available online for public review until February 14, 2005:

<http://www.boe.ca.gov/info/sb157analysis.htm>.

## OVERVIEW

Table 2 summarizes the 81 sections in the Agreement by (1) whether the sections are consistent with current California law, (2) whether they deviate,\* or (3) whether they are not directly applicable. Thirty sections do not directly apply to a specific California statute or regulation; most of these sections concern governance or issue resolution. Of the 51 remaining sections, only seven sections could be adopted without amending a statute or regulation.

**Table 2**

<b>SSUTA: Revenue Impacts and Changes in California Laws or Regulations</b>					
<i>Number of SSUTA Sections</i>		<i>Consistent with or Deviates from CA Law or Regulation?</i>			
		<i>Consistent</i>	<i>Deviate</i>	<i>Not Applicable</i>	<i>Total</i>
Revenue Impact?	No	7	12	29	48
	Possibly	0	9	1	10
	Yes	0	23	0	23
	Total	7	44	30	81

Source: California Board of Equalization, March 5, 2003 and author's calculations.

The majority of the SSUTA sections deviating from California law would have some sort of revenue impact, but the magnitude of this impact varies. In some cases, necessary amendments amount to small changes in wording with little or no revenue impact; in other cases, the amendments would significantly affect the nature of the tax and/or the amount of revenue collected. The full extent of the revenue implications (both positive and negative) is currently unknown, but 23 out of the 81 SSUTA sections (about 25 percent) are estimated to have some revenue impact. Areas of the SSUTA Agreement that would require significant changes in California sales and use tax policy are summarized in Table 3. Subsequent revisions to the Agreement by participating states might require additional changes in California law.

**Table 3**

<b>SSUTA Sections Requiring Fundamental Changes to California Laws or Regulations</b>		
<i>Section Number</i>	<i>Section</i>	<i>Reason for Fundamental Change</i>
309 310 311	General Sourcing Rules	SSUTA uses a destination-based rule (taxed at point of delivery) while CA uses an origin-based rule (taxed at point of sale) in most cases. Changing to a destination-based rule would impact sales tax distribution between localities.
103	Taxing Authority Preserved	Legislatures would choose what goods and services are taxable or exempt in their states. However, participating states would agree to use common definitions for key items in the tax base. This could restrict California's ability to tax specific items that differ from the Agreement's Library of Definitions. This provision could limit CA legislative authority and BOE's involvement.

\* Some sections are divided into subsections. If some subsections are consistent with current law and others deviate, this tabulation counts the entire section as deviating.

Table 3 (continued)		
SSUTA Sections Requiring Fundamental Changes to California Laws or Regulations		
Section Number	Section	Reason for Fundamental Change
316	Enactment of Exemptions	SSUTA rules concerning sales tax exemptions vary significantly from CA statutes.
327	Library of Definitions	Many SSUTA definitions of goods are currently not defined in CA law. Others deviate significantly from CA law. Different definitions could change the taxability of many goods.
501	Vendor Compensation	Currently, California does not compensate vendors.
402	Amnesty	SSUTA rules concerning amnesty vary significantly from CA statutes.
903	Definition Requests	Governance and Issue Resolution: These provisions would limit the involvement of the California BOE and the California Legislature in sales tax policy.
1001	Rules and Procedures for Issue Resolution	
1002	Petition for Resolution	
1003	Final Decision of Governing Board	
1104	Final Determinations	
Source: California Board of Equalization (BOE), March 5, 2003		

### ***General Sourcing Rules, Streamlining's "Speed Bump"***

Should online purchases be taxed based on the buyer's location or the seller's? The location or 'source' of a sale determines which local jurisdiction can levy and collect the local sales and use tax. These provisions of the SSUTA are known as the 'sourcing' provisions. The sourcing provisions apply to state, local and transit district sales and use taxes. States differ in how their localities determine what tax applies in transactions that involve a vendor in one taxing jurisdiction and delivery to a purchaser in another. Within their own borders, states have greater options than when transactions cross state borders, because intrastate trade is not restricted by the federal constitutional protections afforded trade crossing state boundaries. A tax may apply:

- at the location of the *vendor* (origin rule), without regard for whether the buyer takes possession at that time or whether how the purchase is delivered to the purchaser at that time, or,
- at the place of *delivery of the purchased goods* (destination rule), without regard to how that purchase gets delivered.

Under current California law, an origin-based sales tax rule is used for most transactions.\* Local sales tax is generally sourced to the retail outlet where the sale occurs even if the property is shipped or delivered to a location in California, but outside the taxing jurisdiction of the retail outlet. California is one of two origin-rule states that prescribes an origin basis for most localities, but uses the delivery basis for transit districts and


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\* Per Regulation 1802.

special county taxes.\* The origin rule simplifies both compliance and administration. All sales at a retail location are taxable by the same overlay of local jurisdictions. Whether an in-state purchase is delivered or not is not relevant to the tax rate applied or to the records kept by the vendor.

The SSUTA uses a destination rule, which changes the place of sale to the location where the purchaser takes delivery of the purchased item. This rule is neutral with respect to the location of the sale and causes shoppers to have no reason to select stores on the basis of sales tax rates for goods that are shipped. It also puts extraordinary demands on vendors, who must identify the proper rate at the delivery point, maintain accounts of sales to each taxing jurisdiction, file the appropriate taxes due, and potentially satisfy the differing rules of each jurisdiction to which sales are made. A description of the basic differences between sourcing under current California law and under the SSUTA is shown in Figure 3. The hierarchy for general sales tax sourcing rules under the SSUTA are outlined in Table 4. California tax code sections dealing with sourcing are listed in Appendix C.

**Figure 3**

General Sourcing Rules						
Basic Differences Between Current California Law and the SSUTA						
	<p>1) Customer buys items in a store and takes the items to their home or business. In this case, the property is delivered to the customer at the business location of the seller.</p> <p>No difference under current California Law and SSUTA: Sale is sourced to the store's location</p>					
	<p>2) <b>DELIVERED ITEMS:</b> Customer buys items in a store or via the Internet, catalog, mail-order, telephone, etc. and the <i>item is delivered</i> to the customer's home or business.</p> <table> <tr> <th>Current California Law</th><th>SSUTA</th></tr> <tr> <td>(origin-based):</td><td>(destination-based):</td></tr> <tr> <td>For most items, sales are sourced to the store.</td><td>Sales are sourced to location where receipt by the purchaser occurs.</td></tr> </table> <p><b>EXCEPTIONS</b> to California's origin-based sourcing. A few items already use destination-based sourcing under current California law. Examples are the district tax on purchases of motor vehicles, a portion of the local tax on the sale of jet fuel, and the sale of fixtures by a construction contract.</p> <p><b>EXCLUSIONS</b> from general sourcing rules in the SSUTA: watercraft, modular homes, manufactured homes, mobile homes, florist sales, and the retail sale of motor vehicles, trailers, semi-trailers, or aircraft that do not qualify as transportation equipment. Special rules also apply to telecommunications, direct mail, and certain leases and rentals.</p>	Current California Law	SSUTA	(origin-based):	(destination-based):	For most items, sales are sourced to the store.
Current California Law	SSUTA					
(origin-based):	(destination-based):					
For most items, sales are sourced to the store.	Sales are sourced to location where receipt by the purchaser occurs.					

\* Texas is the other state of the vendor/origin group that uses the destination rule for some districts.  
Source: Due and Mikesell, *Sales Taxation*, 1994, p. 293.

**Table 4**

<b>Hierarchy for Sales Tax Sourcing Rules Under the SSUTA</b>	
<i>General sourcing rules are the same for tangible goods, digital products and services (other than telecommunications).</i>	
a	When a product is received by the purchaser at the seller's business location, the sale is sourced to that business location.
b	When a product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser occurs.
c	When (a) and (b) do not apply, the sale is sourced to the location indicated by the address for the purchaser that is available in the seller's records.
d	When (a), (b) and (c) do not apply, the sale is sourced to the location indicated by an address for the purchaser obtained during the consummation of the sale, including the address of a purchaser's payment instrument, if no other address is available, when use of this address does not constitute bad faith.
e	When none of the previous rules of (a), (b), (c), or (d) apply, including the circumstance where the seller is without sufficient information to apply the previous rules, then the location will be determined by the address from which tangible personal property was shipped.
f	A purchaser who plans to use the digital products, computer software delivered electronically, or services concurrently at multiple locations must remit the required tax to the proper jurisdictions ("Multiple Points of Use").

Why did the SSUTA choose the destination-based sourcing rules? For uniformity's sake, a choice had to be made for all states joining the Agreement to source sales one way or another, either by origin or by destination. Most states involved in the early stages of the Streamlined Sales Tax Project were destination-based sourcing states. In addition, from a policy standpoint, if all states imposing sales tax uniformly use destination sourcing, this would eliminate the artificial incentive for retail businesses to locate in any one particular state because of that state's sales tax laws (or lack of them). Also, destination sourcing is generally used for state tax purposes.

In California, the adoption of destination-based sourcing rules might lessen the current competition among cities for big-box retail sales, although a local sales tax with destination sourcing would continue to make big box retailers an attractive fiscal use of land. Many purchases are not delivered and those purchases would continue to bring in significant amounts of revenue to the host locality. Destination-based sourcing rules would also cause major revenue shifts among local jurisdictions. An analysis of the fiscal impact of destination sourcing\* on California cities and counties is currently underway by the BOE and is available at <http://www.boe.ca.gov/info/sb157analysis.htm>. The remaining sourcing sections (Direct Mail and Telecommunications) will be provided in a subsequent report. Expected completion dates for each phase of the general sourcing analysis are:

Phase 1 – Complete analysis of General Sourcing – December 13, 2004.

Phase 2 – Public review and comment period – February 14, 2004.

Phase 3 – Review public comments – March 2005.

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\* SSUTA General Sourcing sections 309, 310 and 311.

Phase 4 – Identify impact study options - July 2005.

Phase 5 – Approval for impact study - Will be based on the results of Phase 4.

Phase 6 – Complete impact study - Will be based on the results of Phase 4 and Phase 5.

Phase 7 – Submit to California Board of Governance - 30 days after the completion of Phase 6.

For California's 476 cities in 1999-2000, sales and use tax allocations per capita followed the distribution in Table 5. The 12 cities with more than \$500 per person in sales tax revenue were: Vernon, Industry, Sand City, Colma, Irwindale, Santa Fe Springs, Commerce, Brisbane, Signal Hill, Emeryville, Corte Madera and Beverly Hills. These cities would likely receive lower sales tax allocations were California to switch from origin-based to destination-based sourcing.

**Table 5**

<b>Sales and Use Tax (SUT) Per Capita for Cities, 1999-00</b>	
<u>SUT per person</u>	<u>Number of California Cities</u>
More than \$1,000	6
\$500 - \$999	6
\$250 - \$499	37
\$100 - \$249	200
\$50 - \$99	119
\$25 - \$49	65
Less than \$25	34
SUT data not available	9
Total Number of Cities	476

The relative merits of destination-based and origin-based sourcing have been extensively debated in the literature and are summarized in the "Evaluations of the SSUTA" section of this report. Michael Greve is one advocate for origin-based taxation, arguing that this system promotes competition, giving states a motive to lower their sales taxes as a means of enticing companies to choose their state as a base of operations.<sup>42</sup> Professor Charles McLure, on the other hand, has argued the merits of destination-based sourcing, which necessitates intergovernmental tax harmonization and simplification.

For origin-rule states, adopting the SSUTA's destination rule will result in both gains and losses to local jurisdictions as the location of sales shifts from retail outlets to where the sales are delivered. Washington is an example of a state that would have to switch from an origin-based rule to a destination-based rule in order to conform to the SSUTA. In response to concerns from local jurisdictions, Washington removed the SSUTA's general sourcing provisions from a 2003 legislative package designed to move Washington into conformity with the Agreement. The legislature also declined to approve legislation to conform the states' sales tax to the destination-based sourcing rule contained in the Streamlined Sales Tax Agreement. No agreement could be reached on how to offset shifts in revenue among localities. Fighting between the winners and losers became intense, and according to the Association of Washington Cities, this is "the most divisive issue in the city family in 25 years."<sup>43</sup>

The Washington Department of Revenue did a study in 2003 on the effects of sourcing and developed mitigation options for those jurisdictions negatively impacted by SSUTA

destination-based sourcing. The study was updated and improved in September 2004.<sup>44</sup> The methodology used in the Washington study is described in Appendix D. Adopting destination-based sourcing does not result in a loss of revenue for the state or for local taxing jurisdictions as a whole. However, revenues would shift among jurisdictions. The sourcing study found that:

“Some of the delivered sales that would be affected by the change in sourcing are delivered to the same jurisdiction in which the sale originates. However, the majority of delivered sales would be shifted to another jurisdiction. When this shifting in sales occurs, individual jurisdictions may incur net revenue losses if sales delivered outside their boundaries exceed the sales delivered inside their boundaries...Cities that would lose revenues generally contain businesses with warehouses or retail stores from which deliveries are made. Delivered goods include office supplies and durable goods, such as office equipment and furniture. Some of these businesses are large department stores selling remotely to households in other jurisdictions. Finally, smaller cities that serve as a local business hub to a larger community also tend to lose sales.”<sup>45</sup>

The study measured all sales that were delivered, and then determined the destination of the sale. The 2004 study found that the value of delivered goods was \$10.5 billion in taxable retail sales in 2002, or 12.2 percent of the total local sales tax base.\* This value of delivered goods included the amount that remained in the same jurisdiction as well as the amount redistributed. If the 12.2 percentage estimate of delivered sales were to apply in California, then \$54 billion in taxable retail sales would have been impacted in 2001.† Concerning the local distribution of losses and gains, the sum of net sales tax losses for all negatively impacted tax jurisdictions in Washington was \$32.0 million; net sales tax gains for all positively impacted tax jurisdictions was \$28.5 million. Tax collection losses and gains do not exactly cancel out to zero because there are different tax rates in different jurisdictions.‡ One trend in the shift of delivered sales was towards unincorporated counties, which have lower-than-average sales tax rates. An estimated 117 cities out of the 281 cities in Washington lost revenues due to the shift in the sourcing of delivered sales. Most of the cities that lost revenue had losses of less than 10 percent of their total basic and optional sales tax revenues. Fourteen cities had losses greater than 10 percent. Proponents of the SSUTA argue that some of these losses would be compensated by increases in revenue from remote sales that are currently untaxed. DOR estimated that in 2002, \$3.1 billion in remote sales were untaxed, a loss of \$200 million for the state and an additional loss of \$59 million for local taxing jurisdictions.<sup>46</sup>

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\* These estimates from the 2004 study are slightly lower than the 2003 study's estimate of \$12.9 billion in delivered goods or 15 percent of the tax base.

† Washington is unique in sourcing delivered goods to the retail outlet from which delivery took place. This sourcing rule has concentrated sales tax collections of delivered goods to a few jurisdictions that have warehouse districts. California does not source sales to warehouse districts, so the 12.2 percent estimate of delivered sales affected by the sourcing change might be too high for California. In 2001, total taxable sales in California were about \$440 billion.

‡ In terms of taxable retail sales, however, the gains and losses do zero out.

To conform with the SSUTA, a number of states are in the process of switching from origin-based to destination-based sourcing. As they implement destination sourcing, states with local sales taxes and large numbers of local taxing jurisdictions have received many complaints. Examples of states to watch are: Arkansas (date of implementation of destination sourcing: 1/1/2004), Iowa (7/1/2004), Kansas (7/1/2003), Ohio (1/1/2005), Texas (7/1/2004), Utah (7/1/2004), North Carolina (1/1/2002), Nevada (7/1/2003), Tennessee (1/1/2004) and Oklahoma (11/1/2003). States that enacted legislation during 2004 to delay implementation include Kansas, Ohio, Texas and Utah.

Kansas, which switched from an origin-based to a destination-based system on July 1, 2003, has had such difficulties with the new system that in early 2004, the Kansas House discussed repealing the new sourcing law or delaying its implementation until national legislation is approved.<sup>47</sup> The change in sourcing sparked such an outcry from small businesses that the Kansas Department of Revenue (DOR) relaxed enforcement for the first six months. For each delivery, businesses must determine the address and zip code of the delivery and then find out what sales tax rate is applied there. Even though the DOR website\* provides the sales tax rate applied for each zip-code-plus-four, business owners in many rural towns reportedly do not have access to high-speed Internet services; moreover, many delivery locations, especially where new homes are being built, don't have addresses in the DOR's computer system.

Despite these difficulties, Kansas retailers are continuing to move toward full compliance with the state's controversial destination-based sourcing. According to testimony in Fall 2004 by Kansas Revenue Secretary Joan Wagon to the Special Committee on Assessment and Taxation, she is optimistic that all retailers will have completed the transition to destination sourcing by the January 1, 2005 target date. The number of retailer returns showing sales in multiple jurisdictions increased by 34 percent in 2004 over a comparable period in 2003 and indicates a successful transition. She also said that during the first six months of 2004, Kansas received at least \$500,000 in use tax receipts as a result of voluntary compliance from out-of-state retailers, and she noted that Kansas's participation in the Agreement was "paying off."<sup>48</sup>

Texas is an example of a state that has enacted conforming legislation, but has tried to protect its export industries and local jurisdictions.<sup>49</sup> Texas stipulated that the SSUTA destination-based sourcing rules shall apply almost everywhere in Texas, except for businesses with only one location. For political reasons, the legislature created sourcing exceptions for Round Rock and a couple of other cities. In the City of Round Rock, home to Dell Computers, origin-based taxation shall continue to prevail. If Dell's sales tax collections were forfeited, Round Rock would lose about \$21.5 million in 2004 and would have to increase property taxes. Round Rock also expects to receive \$350,000 from Sears, Roebuck and Co. in 2004.<sup>50</sup>

For Texas to be in full compliance with the SSUTA, sourcing provisions will have to be addressed. Moreover, Texas has delayed implementation of changes in sourcing set to

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\* The Kansas Sales and Use Tax Address Tax Locator is available at: <http://www.taxwatch.biz/cgi-win/Kansas/TxWStateSite.exe/Lookups>.

take effect July 1, 2004 and no deadline has been set for deciding when the changes will be implemented. The reason for the delay, which is discussed in a report posted on the Comptroller's Web site, is "several members of the Texas legislature as well as many business owners around the state have raised concerns about the significant and far-reaching effects of these changes."<sup>51</sup> Texas expects to complete a sourcing study by December 31, 2004.

In Ohio, forcing small businesses to comply with destination sourcing is a concern. This is especially problematic in one county, Holmes, which has a high concentration of Amish residents, including many furniture makers that do not sell out of state. Requiring those businesses, many of which do not use electricity, to calculate sales tax rates for other jurisdictions within the state would have numerous complications. One plan to protect small businesses is the "Kansas alternative," which means that if a purchase is made at a vendor's place of business and the product is delivered to the customer, it would still be treated as an origin-based transaction, but a telephone or Internet order would be sourced at the point of delivery. *De minimis* exemptions for small businesses that might sell across the county line but not in other states are also being discussed. At the SSTP conforming states committee meeting in Nashville in October 2004, there was reportedly "a lot of sympathy for [the Ohio] position, but not a lot of support for it."<sup>52</sup> In November 2004, Ohio legislators introduced legislation (Rep. Gibbs, HB 407; Sen. Amstutz, SB 218) to provide for origin-based sourcing to protect small businesses. Backers of the measure say the proposed changes could mean Ohio might have to seek an amendment to the SSUTA, depending on how "substantial compliance" is defined.<sup>53</sup>

Another bill would delay SSUTA destination-based sourcing standards by a two-pronged test. Under SB 217, the Ohio tax commissioner would be barred from submitting a petition for state membership in the streamlining compact until the commissioner certifies that a monetary allowance has been established for a "certified service provider." The commissioner would also be required to adopt rules providing for temporary compensation to vendors to help them comply with the destination sourcing standards, in addition to any other compensation that vendors may receive under current law.<sup>54</sup>

An October 2004 report by Chicago's Civic Federation analyzed the potential impact of complying with the SSUTA on Illinois and suggested that "caution and foresight are necessary on the part of the General Assembly" as they weigh the anticipated benefits of coming in compliance with the Agreement with the costs.<sup>55</sup> The change to destination-based sourcing was cited as a potential major economic dislocation for local economies in Illinois. Chicago, for example, would lose up to \$100 million in lease taxes. A change in sourcing would have resulted in a redistribution of \$42 million in local government revenues in 2001. This change was calculated using Illinois sales tax data and the following percentages from the 2003 Washington study: the amount of redistributed local sales tax revenue (15 percent) and the sales tax revenue shifted (1.9 percent).

## ***Taxing Authority and Uniform Definitions***

The goal of the SSTP and its Agreement is to provide states with a sales tax system that includes, among other things, uniform definitions within the sales and use tax laws. Although the Agreement provides that state legislatures will continue to decide what is taxable or exempt, they cannot deviate from the definitions set forth in the Agreement.

In general, if the Agreement defines a product, the legislature may exempt all items within that definition, but cannot exempt only part of the items included within that definition. For example, it could exempt all candy but not just Tootsie Rolls. Or take “soft drinks” as an example. Currently California law generally applies sales tax to carbonated beverages (soda) but does not apply sales tax to non-carbonated beverages such as fruit or vegetable juices. Under the Agreement, this would not be possible: sodas would be defined under “soft drinks” with most non-carbonated beverages. Carbonation does not matter for tax purposes under the SSUTA, but any sweetened beverage is taxed.\* If California chooses to continue to tax sodas under the “soft drink” definition, it would have to tax certain non-carbonated beverages that are currently exempt from tax. Or California could exempt all “soft drinks,” including sodas.

The Agreement does expressly permit legislatures to exempt one item, or base the exemption on the use of the property or the entity making the purchase. The oft-cited example of an entity-based exemption is the purchase of clothing (including diapers) by day care centers. The Agreement would allow purchases of clothing by day care centers, for example, to be exempt from sales tax, but not purchases by individuals, who would still pay sales tax on clothing at retail stores. In order to reduce complexity and promote inter-jurisdictional uniformity, the SSUTA has established a “Library of Definitions.” As Table 6 illustrates, California law deviates significantly from the SSUTA definitions.

### ***Example: Streamlined Sales Tax Project Definitions for Food***

Defining food items for taxation purposes can be tricky. Californians remember the outcry when the “snack tax” was implemented in the early 1990s. If you bought potato chips at the convenience store in a small packet, they were taxed. If purchased at the grocery store in a larger bag, they were not taxed. It was confusing, irritating, and resulted in the passage of Proposition 13 in 1992, which froze the previous statutory definition of “food” for sales-tax purposes into the Constitution.† Such inconsistencies can be found in other states as well. Examples are orange juice (soft drink? fruit juice? fruit?), marshmallows (candy? food?), and Twix bars (candy? cookie?).

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\* Under the SSUTA, sweetened beverages are taxed unless they contain milk, milk substitutes or more than 50 percent fruit or vegetable juice. All sweeteners, including artificial ones, bring the tax into play.

† As a result of the snack tax debacle, the definitions in Section 34, Article 13 of the State Constitution prohibited sales or use taxes on food products, including candy, snack foods, and bottled water, except as provided by statute on January 1, 1993. In 1992-93, this reduced sales and use tax revenue to the state by an estimated \$210 million and to the local governments by \$70 million (Legislative Analyst’s Estimate of Fiscal Impact).

Table 6

<b>Comparison of the SSUTA Library of Definitions to Current California Law</b>	
<i>Library of Definitions*</i>	<i>Comparison with Current California Law</i>
<b>Part I: Administrative Definitions</b>	
Delivery Charges	Deviates.
Direct Mail	Not defined in statute.
Lease or Rental <sup>†</sup>	Deviates. Additional analysis needed.
Purchase Price	See Sales Price.
Retail Sale	Deviates.
Sales Price	Deviates.
Tangible Personal Property	Deviates.
<b>Part II: Product Definitions</b>	
<b>Clothing:</b>	
Clothing	Not defined in statute.
Clothing Accessories or Equipment	Not defined in statute.
Protective Equipment	Not defined in statute.
Sport or Recreational Equipment	Not defined in statute.
<b>Computer-Related:</b>	
Computer	Not defined in statute.
Computer Software	Not defined in statute.
Delivered Electronically	Not defined in statute.
Electronic	Not defined in statute.
Load and Leave	Consistent.
Prewritten Computer Software	Appears consistent. Additional analysis needed.
<b>Food and Food Products:</b>	
Alcoholic Beverages	Deviates.
Candy	Not defined in statute.
Dietary Supplement	Deviates.
Food and Food Ingredients	Additional analysis.
Food Sold Through Vending Machines	Not defined in statute.
Prepared Food	Not defined in statute. Additional analysis needed.
Soft Drinks	Not defined in statute.
Tobacco	Not defined in statute.
<b>Health Care:</b>	
Drugs	Deviates. Additional analysis needed.
Durable Medical Equipment	Deviates. Additional analysis needed.
Grooming and Hygiene Products	Not defined in statute
Mobility Enhancing Equipment	Deviates. Additional analysis needed.
Over-the-Counter Drug	Not defined in statute.
Prescription	Not defined in statute. Additional analysis needed.
Prosthetic Device	Not defined in statute. Additional analysis needed.
Source: California Board of Equalization, 3-5-03 and author's calculations. Note that the SSUTA has declined to define services in general and has decided not to define the "digital equivalent of services." The Agreement does propose defining the "digital equivalent of tangible personal property" (except for canned software).	

\* Detailed SSUTA issue papers are available for the following topics: Amnesty, Certification and Audit Standards, Drop Shipment, Holiday Procedures, Product-Based Exemption, Registration, Return Remittance, Rates and Boundaries Database, Simplified Exemption Administration Process, Sourcing, and Taxes Affected by SSTP Act and Agreement. [http://www.streamlinedsalestax.org/issue\\_papers.html](http://www.streamlinedsalestax.org/issue_papers.html).

<sup>†</sup> The Equipment Leasing Association (ELA) commissioned a study from Ernst & Young analyzing compliance of states with leasing provisions of the Streamlined Sales and Use Tax Agreement. <http://www.elaonline.com/GovtRelations/State/SSTcomp.pdf>.

*To tax or not to tax? It is all a matter of definition...*

Is orange juice a fruit or a beverage? In some states, orange juice is defined as a fruit and is taxed, while in others, it is defined as a beverage and is not taxed.<sup>56</sup> Even the beverage definition can cause confusion. In Wisconsin, for example, fruit juice is exempted from a sales tax on soft drinks, but only if it is 100 percent pure. In other states, drinks with at least 50 percent juice are exempted.<sup>57</sup>



Are marshmallows food or candy? In some states, marshmallows are defined as a food; in others, as candy.

Is a Twix Bar candy or a cookie? It looks like a candy bar, but Twix has flour as an ingredient. The presence of flour suggests Twix is a cookie!



As an example of the complexities involved, several of the SSUTA definitions for food and food ingredients are presented below.<sup>58</sup>

**Food and Food Ingredients:** Substances whether in liquid, concentrated, solid, frozen, dried, or dehydrated form, that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. This definition excludes alcoholic beverages and tobacco.

*“Soft drinks” means non-alcoholic beverages that contain natural or artificial sweeteners. Soft drinks do not include beverages that contain milk or milk products; soy, rice, or similar milk substitutes; or greater than 50 percent of vegetable or fruit juice by volume.*

*“Candy” means a preparation of sugar, honey or other natural or artificial sweeteners in combination with chocolate, fruits, nuts or other ingredients or flavorings in the form of bars, drops, or pieces. Candy shall not include any preparation containing flour and shall require no refrigeration.*

*“Prepared food” means:*

- 1. Food sold in a heated state or heated by the seller;*
- 2. Two or more food ingredients mixed or combined by the seller for sale as a single item;\**
- 3. Food sold with eating utensils provided by the seller, including plates, knives, forks, spoons, glasses, cups, napkins, or straws. A plate does not include a container or packaging used to transport the food.*

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\* This does not include food that is only cut, repackaged, or pasteurized by the seller and eggs, fish, meat, poultry, and foods containing these raw animal foods requiring cooking by the consumer as recommended by the Food and Drug Administration so as to prevent food-borne illnesses.

*States may exclude any of the following from items 1 and 2 above:*

- A. Food sold by a seller whose proper primary North American Industrial Classification System (NAICS) classification is manufacturing in sector 31, except sub sector 3118 [bakeries].*
- B. Food sold in an unheated state by weight or volume as a single item.*
- C. Bakery items, including bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, Danish, cakes, tortes, pies, tarts, muffins, bars, cookies and tortillas.*

### **Exhibit 1**

#### **An Example of Diverging Interpretations of SSUTA Definitions for “Prepared Food” Pre-made Sandwiches Sold in Convenience Stores\***

Under the SSUTA, many states have elected to tax “prepared food” and not tax “unprepared food.” Should pre-made sandwiches sold in convenience stores be taxed? These sandwiches are typically sold unheated, and are “mixed or combined” by third parties, not the convenience store, and so do not qualify as “prepared food” on other grounds. The problem for convenience stores is that nearly all the items they sell are within the proximity of their convenience islands, which include eating utensils.

Minnesota and North Carolina, for example, tax these sandwiches. These states have taken the position on audit that pre-made sandwiches served at convenience stores that make utensils available at a convenience island are “food sold with eating utensils provided by the seller.” The rationale is probably because some customers open the sandwiches and apply condiments at the convenience island and perhaps also take a napkin. In this case, the napkins and utensils are made available to the customer in the immediate area where the food is displayed. Of course, this raises issues of what the definition of “immediate area” is...

Other states have taken the position that merely making utensils available to customers at a convenience island is not enough. In Tennessee, Washington and Texas, for example, the definition of “provided by the seller” that would result in a taxable sale is if an employee individually gives customers a napkin or eating utensil with the food.

A third definition of “provided by the seller” that has been discussed could mean napkins and utensils were made available to the customer anywhere on the seller’s premises.<sup>59</sup>

Under current law, California does not have a definition for “prepared food.” Regulation 1603, taxable sales of food products, provides a number of different situations when food is taxable in California. Only one of these, “hot prepared food products,” is similar to a portion of the SSTP definition of “prepared food.”

This is an area that California still needs to analyze. However, one thing to note is that Article 13, Section 34 of the California Constitution provides that neither the State of California nor any of its political subdivisions shall levy or collect a sales or use tax on the sale of, storage, use or other consumption in this State of food products for human consumption except as provided by statute as of the effective date of this section. The

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\* SSTP food definition issues are discussed at:  
[http://www.streamlinedsalestax.org/meetings/food%20issues\\_10305.pdf](http://www.streamlinedsalestax.org/meetings/food%20issues_10305.pdf)

SSTP definition of “food and food ingredients” provides that a member state may maintain its tax treatment of food in a manner that differs from the definitions provided herein, provided its taxation or exemption of food is based on a prohibition or requirement of that state's Constitution that exists on the effective date of the Agreement.

### ***Taxing Authority and Exemptions***

Under the SSUTA, states can decide what to tax and what to exempt from taxation, but they need to follow the Library of Definitions and cannot exempt only part of a product group. Appendix E shows various exemptions in place across the states. Sales tax law has three types of exemptions: (1) product exemptions, (2) entity-based exemptions, and (3) user-based exemptions. Under the SSUTA, states would have uniform definitions, so product exemptions would be easy to administer. If prescription drugs were not taxed in a certain state, for example, sellers would not collect tax on those products.

Exemptions for entities and users are exemptions because of who or what they are, or how they use a product. To qualify for an exemption, entities and users submit exemption certificates. The SSUTA plans to simplify the exemption process by using uniform exemption certificates\* and relieving sellers from any tax if a purchaser improperly claims an exemption, as long as the seller obtains the required identifying information of the purchaser and the reason for claiming the exemption at the time of purchase. Under current law in California, sellers can be held responsible for nonpayment of tax when a purchaser incorrectly claims an exemption, even though it is often difficult to determine whether an exemption is being properly claimed. To conform to the SSUTA, California would also have to amend its laws so that the states can collect the identifying information of the purchaser and the reason for claiming the exemption.

After December 2005, partial exemptions currently permissible under California law would not be allowed under the SSUTA. Effective September 1, 2001, sales and purchases of the following property in California have been eligible for a partial exemption from the state general fund portion of the tax rate (currently 5.25 percent): farm equipment and machinery, timber harvesting, diesel fuel used in farming activities or food processing, and racehorse breeding stock.<sup>†</sup> A 2004 bill, AB 923 (author: Firebaugh), would have repealed some of these exemptions, but these provisions were not enacted.

### ***Vendor Compensation***

State and local governments that impose sales taxes require sellers to collect/pay the taxes at the point of sale from consumers. Sellers must then remit these taxes to state and local governments. To offset a portion of the economic burden sellers incur as a result of this collection/payment responsibility, many states, although not California, allow sellers to keep a small portion of the tax collected (an “allowance,” or a “vendor discount”). The SSUTA provides for vendor compensation if the vendor uses one of the technology

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\* The certificate of exemption is available at: [http://www.streamlinedsalestax.org/stl\\_exempt\\_1103.pdf](http://www.streamlinedsalestax.org/stl_exempt_1103.pdf).

<sup>†</sup> See <http://www.boe.ca.gov/sutax/sutexempt.htm>.

models or registers voluntarily under SSUTA, so California would have to amend its laws to comply. Details on SSUTA vendor compensation rules are shown in Exhibit 2. The amount to be charged will be determined by contract between the Governing Board and a Certified Service Provider, after the Governing Board has been established. Note that proposed federal legislation (S 1736 and HR 3184) goes beyond SSUTA and would require states to provide reasonable compensation to all vendors.

Appendix F shows states offering vendor discounts. As of January 2004, 19 states, including California, did not compensate sellers directly for any associated compliance costs. Twenty-six states (plus the District of Columbia) provided some type of compensation to sellers, with a U.S. median percentage of slightly below two percent of the tax amount paid. Sellers may also be able to offset the cost of collection in some states through interest earned on taxes that have been collected but not yet remitted (the “float”) or through other financial mechanisms. In other states, however, sellers are required to remit estimated taxes before collecting them; this results in a reverse float (i.e., the state earns interest on the sellers’ money).

Several studies have been commissioned to ascertain exactly how much money sellers expend to collect sales taxes. These studies, however, have been widely criticized as biased because they were conducted either on behalf of states or on behalf of sellers. The Washington Department of Revenue (DOR), for example, completed a cost of sales tax collection study in 1998. They found that the total cost of collecting and remitting sales tax was 6.47 percent of total state and local sales tax collections for small retailers, 3.35 percent for medium retailers and 0.97 percent for large retailers.<sup>60</sup> A 1999 study by Ernst & Young estimated collection costs for multistate firms selling nationally (with collection responsibilities in all 46 states) from 87 percent of taxes collected for small retailers to 14 percent for large retailers.<sup>61</sup> The Washington DOR found the Ernst & Young estimates were too high, biased and only concerned with a limited sector of retailers.<sup>62</sup>

Leadership from the SSTP and the National Retail Federation, along with representatives from state and local government and the private sector, came together to create the Joint Cost of Collection Study. The target deadline for delivery of the study was originally 2003, but raising funds from business donors in a down economy took longer than expected. The names of donors are not publicly available. PricewaterhouseCoopersLLP and the University of Chicago’s National Opinion Research Center, along with other researchers and academics, were commissioned to conduct the two-phase \$875,000 survey. Phase I, a survey mailed to 11,000 retailers nationwide, was completed in Fall 2004. Phase II, the data analysis phase, has still not been completely funded.<sup>63</sup> This study is designed to assist policymakers by providing answers to questions such as:

1. How much does collecting the sales and use tax under the current system cost sellers?
2. How much will the simplifications recommended by the SSUTA reduce these costs?
3. What residual costs of collection remain in the simplified system?

## **EXHIBIT 2:**

### **Vendor Compensation under the SSUTA**

The monetary allowances required under the Streamlined Sales and Use Tax Agreement will be provided to sellers using the technology models under the Agreement and to those not using the technology models who voluntarily register in a state under the Agreement.

The monetary allowances are summarized as follows:

#### **Certified Service Providers (CSP)**

The amount is determined by contract between the Governing Board and a CSP and may be one or more of the following:

1. A base rate that applies to taxable transactions processed by the CSP.
2. For a period not to exceed twenty-four months following a voluntary seller's registration through the Agreement's central registration process, a percentage of tax revenue generated for a member state by the voluntary seller for each member state for which the seller does not have a requirement to register to collect the tax.

This monetary allowance is in lieu of a vendor discount that may be offered by the state (i.e., the vendor discounts referred to in Appendix F of this report).

#### **Sellers Using Certified Software**

The amount is determined by the Governing Board once the rate has been established for Certified Service Providers. All sellers will receive a base rate for a period not to exceed twenty-four months following the commencement of participation by a seller. In addition, seller's voluntarily registering in a state will receive a percentage of tax revenue generated for a member state by the voluntary seller for a 24-month period following registration. This monetary allowance is in addition to a vendor's discount that may be offered to the seller by the state.

#### **All Other Sellers**

Those sellers that voluntarily register under the Agreement will receive a percentage of tax revenue generated for a member state by the voluntary seller for a 24-month period following registration.

This monetary allowance is in addition to a vendor's discount that may be offered by the state.

Note: Sellers currently registered to collect sales or use tax in a state that do not use either of the technology methods receive no monetary allowance under the Agreement. The only compensation the retailer receives is the vendor discount a state may allow under current law. Federal legislation introduced in 2004 to authorize states that are parties to the SSUTA to mandate collection by remote sellers did contain a provision that required reasonable compensation to all retailers.

## ***Amnesty***

The SSUTA is promoting an amnesty for uncollected or unpaid sales and use taxes to a seller that registers to pay and/or to collect and remit applicable sales and use taxes on sales made to purchasers in a state. The amnesty is an incentive to remote sellers to begin collecting and remitting sales tax to the state. Sellers who are required to collect sales and use taxes under current law, but have failed to do so, may be eligible for amnesty from assessment of back taxes and penalties. Some remote sellers may want amnesty because their current activities may have potentially created nexus (the legal obligation to collect tax) in a state. Other remote sellers want amnesty because it will enable them to consolidate their Internet and in-store activities or increase their markets without risking potential tax liabilities for past periods. To receive amnesty, the remote seller must agree to collect and remit taxes for a period of 36 months to all member states of the SSUTA. Therefore if a remote seller registers under the SSUTA for whatever reason, it will be required to collect and remit tax on sales in all member states of the Agreement.

The SSUTA amnesty is applicable to sellers that register within 12 months of the effective date of a state's participation in the Streamlined Sales Tax System. The amnesty is not applicable to sellers that were registered in a state in the 12-month period preceding the commencement of the state's participation in the system. The amnesty is also not available to sellers under audit or to sales and use taxes owed by a seller in their capacity as a buyer. States may allow amnesty on terms and conditions more favorable to the seller than what is provided in the Agreement between participating states.<sup>64</sup>

In California, in cases of an underpayment of sales or use tax, the state is supposed to send a notice of tax due (a notice of deficiency determination) within about three years after the return is filed or the sale or purchase took place. In the case of failure to file a tax return, the notice of determination needs to be sent within eight years.

Current California law does not provide for sales tax amnesty, but the law does provide for partial amnesty with respect to use tax obligations.\* Specifically, in cases where a California purchaser fails to file a return and report the use tax obligations, or when an out-of-state retailer that has California nexus fails to register with the Board of Equalization (BOE) and report use tax on its sales to California consumers, the statute of limitations with respect to past use tax obligations is shortened to three years - as long as the California purchaser or the out-of-state retailer had not been previously registered with the BOE or contacted by the BOE regarding use tax obligations. These provisions of law also provide for relief of penalties if the BOE finds that the purchaser's or retailer's failure to file a return was due to reasonable cause.

## ***Centralized Registration***

The SSUTA proposes an online centralized registration system that will allow sellers to register in all of the participating states. By registering in this system, the seller would agree to collect and remit sales and use taxes for all taxable sales in participating states.

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\* California's Revenue and Taxation Code Sections 6487.05 and 6487.06.

According to the SSUTA, registration with this central system will not be used as a factor in determining whether the seller has nexus with a state for a business activity tax, such as the income or franchise tax.

In Summer 2004, controversy erupted over who should operate the online registration system after its development is completed. At the request of the Streamlined Sales Tax Project, the Multistate Tax Commission (MTC) has been developing the system. The MTC plans to finish developing the system by January 1, 2005, but its operation awaits the SSUTA Governing Board's formation by the middle or later half of 2005. Although an official decision has yet to be made for the MTC to run the registration system, Council on State Taxation (COST) members have said they would likely not participate if the MTC runs the system. Members of a National Conference of State Legislatures task force have also voiced their concerns with SSUTA plans for the registration system. According to COST Tax Counsel Stephen Kranz, COST fears the MTC will use the registration information to audit them.<sup>65</sup> Following the August 2004 meeting of the Conforming States Committee, COST surveyed its membership and asked whether COST should continue to oppose MTC operation of the centralized vendor registration system. Of the 287 COST members who responded, 274 members, more than 95 percent of the total, indicated continued opposition.<sup>66</sup>

Reasons for COST opposition to the MTC operation of the centralized vendor registration system are several. First, COST members have concerns over the MTC's historical treatment of taxpayers. They feel that MTC operation of the system would jeopardize the "fresh start" of the SSTP and would imperil the goodwill generated thus far through significant taxpayer/state government cooperation. Second, the MTC represents a different constituency than the SSTP and is therefore an inappropriate body to charge with the operation of the system. Not all SSTP states are voting members of the MTC; nor is every MTC member a sales tax state. The MTC and large taxpayers have strong disagreements over what constitutes "substantial nexus" for state tax jurisdiction and over privacy issues concerning the collection and centralization of sensitive taxpayer information. Finally, the MTC has responsibilities outside the sales tax arena that make it an inappropriate body for the operation of the centralized registration system. The MTC conducts income and franchise tax audits for non-SSTP states and has taken the position that out-of-state taxpayers can be assessed income or franchise tax even absent a physical presence in a taxing jurisdiction. This policy position, combined with the MTC's audit function, has taxpayers concerned that MTC access to information in the central registration system will be used to supplement its audit function.<sup>67</sup>

In January 2005, the SSTP changed direction on the issue of the centralized vendor registration system: the Conforming States Committee (CSC) approved the issuance of a request for proposal (RFP) for the development, maintenance and hosting of the centralized registration system. In a second motion, the Committee authorized the co-chairs of the CSC and SSTIS committees to enter into an agreement with MTC to develop the central registration system if the RFP process did not produce an outcome that was in the best business interests of the states. The RFP process could postpone the registration system's launch date to a new target, June 30, 2005. In a third motion, the

Committee rescinded an October 2004 motion that directed the Committee to enter into a memorandum of understanding with the MTC for the registration system's development.

### ***Governance and Issue Resolution***

California's acceptance of the Agreement would have a significant impact on the role of Board of Equalization members and the California legislature in making and enforcing sales and use tax policy. California would lose some of its "sovereignty" with respect to that policy, in exchange for the ability to tax remote sales. The SSUTA Governing Board would be responsible for interpretations of the Agreement, amendments to the Agreement, and issue resolution. The Governing Board will comprise representatives of each member state of the Agreement, with each member state entitled to one vote. Votes are not weighted to reflect a state's population. The fee structure for member states was discussed in August 2004 and has not been finalized. A recommendation was made for a fee structure based on the state's population and the amount of taxable sales.

Seeking to limit federal intervention in states' sales tax streamlining efforts, the Multi-state Tax Commission approved a policy calling for a "state-based process to review decisions of the project's governing board." This July 30, 2004 decision was approved by 15 to 0, with one abstention from New Mexico, which is not a member of the SSTP. The proposed federal legislation authorizing the SSUTA included a review of governing board actions by the Federal Claims Court "that would establish a precedent of federal court jurisdiction," said MTC Executive Director Dan Bucks. Moreover, there was a concern that a federal court would lack knowledge of state tax policy.<sup>68</sup>

### ***Outstanding Issues***

States involved in the Streamlined Sales Tax Project continue to meet to resolve outstanding simplification issues, including those involving registration and returns, bundling (a retail sale of multiple products for one price, such as tangible personal property and a service), certificates of state compliance with the Agreement, digital property, telecommunications, certifications, audit, exemptions and sourcing.<sup>69</sup> Minutes from the bi-monthly meetings of SSTP states are available at:

<http://www.streamlinedsalestax.org/meetings.html>.

A state is in compliance with the SSUTA if the effects of the state's laws, rules, regulations and policies have been certified to be substantially compliant with each of the requirements set forth in the SSUTA. The certification process includes a review of the state's certificate of compliance by the other conforming states and representatives from the business group. This review process has identified a number of issues that will prevent the certification of some states. According to the California State Board of Equalization's September 2004 report, some of the issues identified are:<sup>70</sup>

- (1) Failure to pass complete conforming legislation. The main provisions that were not passed are: Amnesty provisions, Liability protection for retailers, Definition of medical equipment, Definition of sales price, and General sourcing rules.

- (2) Delayed effective dates of conforming legislation: A state cannot be certified to be in substantial compliance with the SSUTA until the conforming legislation is effective. A number of states have effective dates in 2005 or provisions that the legislation is effective when the Governing Board is created.
- (3) State's conforming legislation includes different interpretations of SSUTA sections.
- Definitions for prepared food. Several states used different criteria to determine when eating utensils are provided to the customer. (See Exhibit 1.)
  - Definition of sales price. Several states differ on what amounts are included in the sales price of a purchased item. When a manufacturer's rebate is involved, for example, some states tax the gross receipts of the retailer and other states tax the total payment by the customer.<sup>71</sup>
- (4) Phased-in implementation of general sourcing rules. Several states will phase in the implementation of the general sourcing rules. These states might not be in substantial compliance with the SSUTA until the phased-in implementation is complete.

## **NEW PROCEDURES, DATABASES AND SYSTEMS**

Joining the Agreement would require California to institute a number of new procedures, databases and systems. Examples of these are outlined in Table 7. Most would entail costs for development, implementation and maintenance. The Project has proposed three technology models. A seller could choose one of these three technology models or continue to use a traditional tax collection system (i.e. continue to calculate, pay and report sales tax under current procedures). If a seller chooses one of the technology models, as certified by the states, the seller would benefit from reduced liability and audit scope.

- Model 1 is a Certified Service Provider (CSP). A seller selects a CSP as an agent to perform all of the seller's sales tax functions at no cost to the seller. The CSP then determines the amount of tax due, pays the tax to the states, and files returns with the states. The states will compensate the CSPs through a transaction fee, percentage of revenues collected, or some combination. The states anticipate that several entities will be able to meet the requirements for a CSP. The CSP will be liable for the tax due unless there are errors by the states or fraud by the seller. The CSP will be subject to audit and periodic system checks by the states. Any audit will be a joint audit performed on behalf of all the states in the Streamlined Sales Tax System.
- Model 2 is a Certified Automated System (CAS). A seller selects a CAS to calculate the amount of tax due on a transaction. Sellers benefit from the use of a CAS because they can use standardized software certified by the states as accurate. The CAS would be subject to periodic system checks and the seller would be subject to audit on its tax remittance and return filing functions.
- Model 3 is a proprietary system that would be certified by the states as a Certified Automated System (CAS). This model will accommodate large sellers with

nationwide sales that have developed their own sophisticated proprietary automated sales tax systems. A seller with a proprietary system must agree to several conditions to obtain certification of its system.\*

An example of one new procedure, the taxability matrix (SSUTA section 327), is reproduced in Appendix G. When applying for SSUTA compliance, each state will submit a taxability matrix, which gathers information about the state's tax treatment of the products defined by the SSUTA as well as administrative definitions.

**Table 7**

<b>SSUTA Procedures, Databases and Systems That Would be New to California</b>	
<i>SSUTA Section</i>	<i>New Procedure, Database, or System</i>
202	Accept Certified Automated System (CAS).
203	Accept Certified Service Provider (CSP).
211	Revise seller registration process; contribute to the development of a central registration system; update IRIS system. <sup>†</sup>
303	Maintain secondary registration process for sellers not participating in SSTP.
305	Develop a zip code database; work toward developing an address-based system.
312	Develop Multiple Points of Use (MPU); Continued tracking of MPU.
313	Develop Direct Mail Sourcing.
317	Revise direct pay program; develop new software program; increase audits of purchasers.
318	Develop a uniform SUT return, a second SUT return; and an electronic return system.
319	Eliminate prepayment return; increase number of prepayment remittances received; possible development of new coding system for payment types.
320	Develop system and procedures to allocate bad debts to other states.
321	Develop system and procedures to contact person.
326	Expansion of direct pay program.
327	Develop taxability matrix (see example in Appendix G).
401	Develop an online seller registration system.
501	Accept SSTP certification process for CAS and CSP.
Source: California Board of Equalization, March 5, 2003.	

\* The seller must agree to process all its sales using the system, to meet an accuracy standard set by the states, to agree to a methodology for determining whether the system is meeting the established performance and accuracy standards, and to allow the states to periodically examine its system.

<sup>†</sup> The Integrated Revenue and Information System (IRIS) processes sales and use tax schedules.

## IMPLEMENTATION OF SSUTA’S 25 PRINCIPAL REQUIREMENTS IN CALIFORNIA AND OTHER STATES

Table 8 expands the Board of Equalization preliminary analysis of the potential impact of the Agreement on California sales and use tax law, focusing on 25 major sections in the SSUTA and how they might affect California law. For each of the 25 Agreement sections, examples of other states that have needed to change laws to comply with individual SSUTA requirements as well as examples of California laws that would need to be amended are listed. These laws are summarized in Table 9. Further analysis is needed, so not all California laws needing amendment are listed. Subsequent revisions to the Agreement by participating states might require additional changes in California law.

**Table 8**

<b>Principal Requirements: Streamlined Sales &amp; Use Tax Agreement</b>		
<i>25 Major Sections of the Agreement (by SSUTA section number)</i>	<i>CA Revenue &amp; Tax Laws Require Amendment or New Provision?</i>	<i>Issues for Other States<sup>72</sup></i>
<b>1. Tax Authority Preserved (103)</b> – Each state can determine the specific taxes to which the agreement applies. States should avoid creating new excise or other taxes to maintain the tax treatment of a particular category of property or service.	Could limit the tax authority of the California legislature by restricting its ability to tax specific items or areas that differ from the Agreement’s Library of Definitions.	Minnesota’s special fur tax on clothing; <sup>*</sup> Alabama’s rental tax. <sup>†</sup>
<b>2. Level of Administration (301)</b> - State-level administration must be provided for local sales and use taxes.	None. The BOE already administers the combined state and local sales and use taxes	AL, AR, AZ, CO, LA
<b>3. Single Tax Base (302)</b> – Through 12/31/05, all local jurisdictions in the state must have a common tax base. After that date, the local tax base must match the base of the particular state.	No action necessary now. After 12/31/05, the five percent exemptions in current law would require amendment. Revenue & Tax Code § include: 6356.5, 6356.6, 6357.1, 6358.5, 6377, 6378, 7202, 7203.	CO
<b>4. Seller Registration (303)</b> – Requires an online sales and use tax registration system to be used by the member states. Agents of sellers can register on behalf of sellers.	Law currently requires sellers to register but is silent with respect to agents. § 6066 and 6226 would require amendment.	
<b>5. Notification of Rate Changes (304 &amp; 305)</b> Member states must make a reasonable effort to give sellers as much advance notice as practicable regarding rate changes, limit the effective date to the first day of a quarter, and notify sellers of legislative changes in the tax base	§ 7265 now requires all district taxes to be operative on the first day of the calendar quarter commencing more than 110 days after an ordinance is adopted. No amendment necessary.	

\* Minnesota enacted the STTP definition of “clothing,” which encompasses fur, but then created a new “special fur tax.” The new tax was designed to allow Minnesota to continue its pre-existing sales tax exemption for all clothing except fur, and was viewed by many as a violation of SSTP’s uniformity. The Council on State Taxation (COST) has criticized the Agreement for failing to adequately discourage states from shifting sales tax complexity to other taxes.

† COST has criticized the SSUTA for excluding sales taxes such as the Alabama rental tax from its scope.

Table 8 (continued)

<b>Principal Requirements: Streamlined Sales &amp; Use Tax Agreement</b>		
<i>25 Major Sections of the Agreement (by SSUTA section number)</i>	<i>CA Revenue &amp; Tax Laws Require Amendment or New Provision?</i>	<i>Issues for Other States<sup>20</sup></i>
<b>6. Reduction of Multiple Tax Rates (308)</b> a. Cannot have multiple tax rates on items of personal property or services after 12/31/05. b. Local jurisdictions levying both a sales and use tax must use the same rate for each. c. Member states must provide and maintain a database that assigns each five-digit and nine-digit zip code to a tax rate, applying the lowest rate if the area includes more than one tax rate.	a. No action required b. No action required. c. Administrative costs.	Second state rate (=0) for food and drugs at the urging of Illinois.
<b>7. Uniform Sourcing Rule (309-315)</b> – a sale must be sourced to the destination where the purchaser receives the item sold, according to a specified hierarchy,* with a default to origin-based sources in the absence of other information. This rule applies to interstate and intrastate sales.	Most sales are currently origin-based: CA law defines place of sale for purposes of state and local sales tax as the place of business of the retailer.† Revenue & Tax § requiring amendment: 6010.5, 6012.5, 7205 and 7263. Multiple Points of Use currently is not defined in CA law.	
<b>8. Direct Pay Permits (326)</b> – allows the holder of a direct pay permit to purchase otherwise taxable goods and services without payment of tax to the supplier at the time of purchase. Holder of permit pays tax directly to the tax jurisdiction.	Each state can set its own limits and requirements for direct pay permits; the Governing Board shall advise member states when setting direct payment limits and requirements. No amendment required to CA law, but the advice of the Governing Board may result in an expansion of the direct pay program.	DC, HI, NV, NM, RI, UT do not currently provide for direct pay permit authority.
<b>9. Exemptions (316-317)</b> – Agreement limits states' ability to exempt defined products, eliminates the current good faith requirement for sellers that follow specified procedures when receiving an exemption certificate, and requires states to hold purchaser liable for tax if an exemption is improperly claimed. Sellers must maintain proper records and provide them when requested. Member states must relieve sellers from tax if they have followed the exemption procedures of the Agreement.	California requires that sellers accept exemption/resale certificates in good faith to be relieved of liability. Sections requiring amendment include § 6092, 6242 and 6421.	
<b>10. Uniform Tax Returns (318)</b> – Requires only one return per taxing period per seller per state. Returns must be due no sooner than the 20 <sup>th</sup> day of the month following the month in which the transaction occurred. Must be capable of electronically accepting filed returns.	CA law requires the BOE to prescribe the form of the return. § 6452 would require amendment.	

\* See hierarchy table for sourcing rules, Table 4.

† Some exceptions to this rule include sales of jet fuel, motor vehicles, and factory-built school buildings.

**Table 8 (continued)**

<b>Principal Requirements: Streamlined Sales &amp; Use Tax Agreement</b>		
<i>25 Major Sections of the Agreement (by SSUTA section number)</i>	<i>CA Revenue &amp; Tax Laws Require Amendment or New Provision?</i>	<i>Issues for Other States<sup>20</sup></i>
<b>11. Uniform Rules for Remittances (319)</b> (a) Requires only one remittance per tax return unless seller collected over \$30,000 in sales and use tax during the prior calendar year.  (b) Requires, at the state's discretion, all Model 1, 2 and 3 sellers to file returns and remittances electronically.	(a) This essentially eliminates monthly prepayments for many taxpayers (currently, prepayments are required for sellers with about \$15,000 in annual tax). Revenue & Tax § 6471 and 6474 would require amendment. (b) Only taxpayers with \$20,000 or more in tax liability are required to remit tax electronically. § 6479.3 would require amendment.	
<b>12. Bad Debt Recovery (320)</b> – Sellers must be allowed a deduction for bad debts pursuant to specified federal rules.	§ 6055 would require amendment	
<b>13. Sales Tax Holidays (322)</b> – The state may not apply an exemption after 12/31/04* unless certain conditions are met, including the exempted item has to be defined under the uniform definition provisions.	Not applicable. California does not have tax holidays.	CT, DC, FL, GA, IA, MD, NY, NC, PA, SC, TX, WV
<b>14. Caps and Thresholds (323)</b> – The state shall not have caps or thresholds on the rates or exemptions based on the value of the transaction or item after 12/31/05, except with respect to mobile homes, modular homes, and selected other items. There is also a special exception for thresholds for sales tax holidays – Section 322 B.	CA law taxes sales of factory-built school buildings at 40 percent of the sales price. Monetized bullion exemption has a threshold. § 6012.6 and § 6355 would require amendment after 12/31/05.	AR, <sup>†</sup> CT, FL, IA, KS, LA, ME, MD, MA, NY, <sup>‡</sup> ND, OH, SC, TN, TX, VT, WI
<b>15. Rounding Rule (324)</b> – after 12/31/05, states must round the amount of tax up to the next whole cent whenever the third decimal place is four. Sellers must be allowed to elect to compute the tax due on an item or invoice basis and apply the rounding rule to the aggregated state and local taxes. No seller may be required to collect tax on a bracket system.	CA law (Civil Code) prescribes a similar rounding rule.	Maryland and Ohio rounded up when any fraction of one cent is involved.
<b>16. Customer Refund Procedures (325)</b> – Provides a first course of remedy for a purchaser's overpayment of use tax to a seller. <sup>§</sup>	Does not appear to require amendment.	

\* Amendment to SSUTA 11/03.

<http://www.streamlinedsalestax.org/SSTP%20Holiday%20Defintions.pdf>.

<sup>†</sup> Arkansas has a local cap on the first \$2,500 of gross receipts from single transactions.

<sup>‡</sup> New York exempts clothing priced less than \$110.

<sup>§</sup> As states and businesses are reviewing certificates of compliance, this provision has been noted as missing from some states' laws – specifically the presumption that a seller had reasonable business practice in setting rates.

**Table 8 (continued)**

<b>Principal Requirements: Streamlined Sales &amp; Use Tax Agreement</b>		
<i>25 Major Sections of the Agreement (by SSUTA section number)</i>	<i>CA Revenue &amp; Tax Laws Require Amendment or New Provision?</i>	<i>Issues for Other States<sup>20</sup></i>
<b>17. Uniform Definitions of Goods and Services (327)</b> – for tangible personal property such as food, clothing, drugs, medical equipment, computers, etc.	Amendments are required and further analysis is necessary. Many Agreement definitions differ from CA law and could have significant impacts. For example, concerning drugs and medical equipment, Sections requiring amendment include § 6369, 6369.1, 6369.2, 6369.4 and 6369.5.	The uniform definitions have elicited opposition in many states. Some definitions still have not been resolved.
<b>18. Exceptions (105)</b> – Agreement does not apply to vending machine sales. Some provisions do not apply to taxes on the retail sale or transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, and mobile homes.*		
<b>19. Registration and Amnesty (402)</b> – Agreement mandates the creation of an online registration system to be used by sellers who volunteer to collect sales and use taxes. Sellers who register must be given an amnesty for uncollected or unpaid taxes under most circumstances.†	Current CA law does not allow sales and use tax amnesty. § 6487.05 would require amendment.	11/13/02 – A coalition of remote sellers has volunteered to register and collect SUT in states in which they do not currently do so, in exchange for amnesty. <sup>73</sup>
<b>20. Vendor Compensation and Technology Models for Remittance (501)</b> – The Governing Board will certify automated systems (CASs) and services providers (CSPs) to aid in the administration of SUT collection. Three models are proposed:‡ Model 1 services providers are to be compensated by the states; Model 2 and 3 sellers are to obtain compensation for 24 months and other compensation allowed by state law.	New provisions would be required. CA has never compensated vendors for duties to collect CA sales and use tax.	
<b>21. Relief of Liability (306)</b> - States are to relieve sellers and certified service providers from liability for having charged and collected the incorrect amount of tax as a result of relying on erroneous data provided by a state on rates, boundaries, taxing jurisdictions, or other information in the taxability matrix.	§ 6596 would require amendment. California relieves persons from liability only under specified circumstances.	The version of the Act enacted in AL, AZ, IA, KS, MO, VA does not contain the liability and audit limitation provisions.

\* Provisions that do not apply are the single tax base and rate requirements, the elimination of caps and thresholds, and the uniform sourcing rules.

† Exceptions to amnesty exist if the vendor was registered with the state within the 12-month period preceding the State's participation in the SSTP Agreement, the vendor received notice of an audit, which is not yet resolved, or there is fraud or intentional misrepresentation.

‡ Participating sellers could continue under the current system for remittances, at least initially. However, they would not qualify for the limitations on audit exposure.

**Table 8 (continued)**

<b>Principal Requirements: Streamlined Sales &amp; Use Tax Agreement</b>		
<i>25 Major Sections of the Agreement (by SSUTA section number)</i>	<i>CA Revenue &amp; Tax Laws Require Amendment or New Provision?</i>	<i>Issues for Other States<sup>20</sup></i>
22. <b>Taxability Matrix (328)</b> - States are to complete a taxability matrix. Sellers and CSPs are relieved of liability due to incorrect reporting due to reliance on the matrix.	§ 6596 would require amendment to relieve sellers and CSPs for any liability arising due to reliance on matrix.	
23. <b>Audit Procedures (301)</b> – States must conduct, or authorize others to conduct on their behalf, all audits of sellers registered under this Agreement. Local jurisdictions shall not conduct independent sales or use tax audits of sellers registered under the Agreement.	No amendment appears necessary.	
24. <b>Confidentiality and Privacy Protections (321)</b> – Model 1 certified service providers must not retain personally identifiable information about customers. Testing is required to verify.	No amendment required.	
25. <b>Governance</b> – “A state is in compliance with the Agreement if the effect of the state’s laws, rules, regulations and policies is substantially compliant with each of the requirements set forth in the Agreement.” Governance provisions include effective date, approval of initial states, entry and withdrawal, advisory councils, issue resolution, amendments and interpretations.	Governance provisions would limit the scope of activities of the California Board of Equalization and the Legislature.	

**Table 9**

<b>Examples of California Revenue and Tax Code Sections Needing Amendment</b>								
<i>Required by SSUTA</i>						<i>Required by Library of Definitions</i>		
						<i>Part I</i>	<i>Part II*</i>	
6010.5	6226	6358.5	6369.5	6471	7202	1541.5	6007	6359
6012.5	6242	6369	6377	6474	7203	1628	6011	6369
6012.6	6355	6369.1	6378	6479.3	7205	1660	6012	
6055	6356.5	6369.2	6421	6487.05	7263	1661	6015	
6066	6356.6	6369.4	6452	6596	7265	6006	6016	
6092	6357.1						6379.5	
Source: California Board of Equalization, March 5, 2003.								
*Sales and Use Tax Regulations 1591, 1602 and 1603 would also need amendment.								

## UNCOLLECTED USE TAX REVENUE

Use tax applies when a person or business in California purchases tangible merchandise from a retailer outside of this state that will be *used, consumed, given away, or stored* in this state. The Board of Equalization (BOE) encourages purchasers to voluntarily register and pay their use tax obligations. The use tax applies to remote sales, which are goods bought over the Internet or through a mail-order catalog and shipped to California from an out-of-state address by a company that does not have a physical presence (nexus) in California. California does not levy sales or use tax on Internet service providers and does not impose a tax on charges for information delivered electronically (downloaded), since it does not consider this a transfer of tangible personal property.\* Custom software and license agreements are not taxable. Canned software and license agreements are taxable if delivered via tangible media (e.g., tape, disk, diskette, CD-Rom, etc.).† Internet auction purchases (on eBay, for example) are currently exempt from sales/use tax if they are considered occasional sales, i.e. sales that are assumed to occur no more than 3 times per year per seller. A large number of eBay sellers would not qualify as occasional sellers.‡ Accordingly, sales and purchases from these sellers could be subject to tax.

The inability to collect use tax has important implications that go beyond the reduction of sales and local government tax revenues. Firms, for example, have an incentive to locate production and sales activity to avoid tax collection responsibility, thereby imposing economic efficiency losses on the overall economy. In addition, the sales tax becomes more regressive: those who are least able to purchase online (because they do not have a credit card or access to a computer) are more likely to pay sales taxes than those who purchase online more frequently.<sup>74</sup>

## MAGNITUDE OF UNCOLLECTED STATE AND LOCAL USE TAX REVENUE

Estimating revenue losses from remote sales, and especially from e-commerce, is difficult. E-commerce has grown markedly, but a major portion is business-to-business sales (B-to-B). A large share of such transactions is exempt from the sales tax. The rest of business-to-business e-commerce purchases are subject to use taxes, most of which are already paid by businesses. Many of these businesses are subject to audit; compliance with the use tax is estimated to be fairly high.§ The consumer portion of e-sales (also called business-to-consumer, or B-to-C e-sales) is growing, but consumer compliance with the use tax is low. Estimates of revenue losses due to these purchases vary widely, reflecting the uncertainty arising from inadequate data. According to the Congressional Budget Office:

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\* California is one of 16 states that do not tax software if it is downloaded (State Taxation Institute, 2000).

† Canned software is a pre-written program developed for general or repeated sale or lease, such as Excel, Word, etc. Custom software is a computer program created and tailored specifically for a particular customer application. The definition includes modification of “canned” software at a charge of 50 percent or more than its original purchase price.

‡ Forrester Research reports that online auctions soon will account for almost \$48.5 billion in sales. eBay facilitated sales of \$24 billion worth of items in 2004. At any one time, eBay has 105 million registered users and 25 million items on its Web site. Source: Shafroth, *State Tax Notes*, January 31, 2005.

§ The Board of Equalization assumes an 80 percent use tax compliance rate for businesses.

Factors that must be estimated include the rate of growth of e-commerce; the proportion of e-commerce that is not part of the sales tax base; the share of e-commerce that is part of the tax base but that represents purchases by exempt entities; and the proportion of taxable e-commerce on which tax is already being collected and that replaces other forms of remote sales.<sup>75</sup>

All such estimates are speculative, but revenue losses may be significant and growing. In any case, while it is clear that online shopping reduces sales and use tax revenues, many analyses imply or assert that consumers deliberately shop online to avoid sales tax. Jupiter Research has commented that this is not necessarily the case: “It’s unclear how seriously sales taxes would dent the appeal of Web shopping. In a recent survey by Jupiter Research, more than 25 percent of users said sales tax never figures into their decision on where to shop, while 54 percent weren’t even aware they could avoid sales tax by shopping around at different sites.”<sup>76</sup>

### ***Estimates of Revenue Losses for California From Remote Sales***

- According to California Board of Equalization estimates, remote sales (including e-commerce and mail order sales) cost state and local governments a total of \$1.345 billion in lost sales tax revenue in 2003. This represented losses of \$282 million in mail order, \$208 million in B-to-C e-commerce, and \$855 million in B-to-B e-commerce.<sup>\*77</sup> While B-to-C losses due to e-commerce increased rapidly between 2001 and 2003, losses due to mail order declined, suggesting that consumers were substituting purchases over the Internet for purchases through mail catalogs.

**Table 10a**

<b>California Revenues Losses Due to Remote Sales, 2001 and 2003: CA BOE</b> (\$ millions)					
	B-to-C			B-to-B Manufacturing	Total Revenue Loss
	Total B-to-C	E-Commerce	Mail Order		
2001	\$456	\$147	\$309	\$783	\$1,239
2003	\$490	\$208	\$282	\$855	\$1,345

Source: California State Board of Equalization (BOE), Revenue Loss Estimates: April 2002, May 2004.

- A 2004 national study with individual state estimates for losses due to e-commerce done by Professors Donald Bruce and William Fox estimated that according to a low-growth scenario, the cost of e-commerce in lost tax revenues to California state and local governments will increase from about \$2.1 billion in 2003 to \$3.0 billion in 2008 (see Table 10b).<sup>78</sup> Under a high-growth scenario, California’s state and local tax losses will grow from \$2.2 billion in 2003 to \$4.6 billion in 2008. State government losses alone will account for about 78 percent of the total. Much of this revenue would not have been collected even without e-commerce, as consumers and businesses would have made some of these purchases through other remote means. “New” losses due to e-commerce were \$1.1 to \$1.2 billion in 2003 and \$1.6 to \$2.5 billion in 2008.

\* In 2001, California’s taxable B-to-C e-commerce sales were an estimated \$3.8 billion; taxable B-to-B manufacturing sales were \$49 billion. In 2003, comparable figures for California’s B-to-C sales were an estimated \$5.26 billion and for B-to-B manufacturing sales, \$54 billion.

**Table 10b**

<b>California Revenues Losses Due to E-Commerce, 2003 and 2008: Bruce/Fox 2004 (\$ millions)</b>						
	Low-growth scenario			High-growth scenario		
	State + Local	State	New*	State + Local	State	New
2003	\$2,129.3		\$1,122.6	\$2,218.9		\$1,167.4
2008	\$2,954.6	\$2,317.4	\$1,619.1	\$4,620.4	\$3,624.0	\$2,452.0
Source: Bruce and Fox, University of Tennessee, Center for Business and Economic Research, July 2004.						

- The Bruce/Fox 2001 projections of California revenue losses due to e-commerce (see Table 10c) were higher than their 2004 projections. In 2001, California's e-commerce sales resulted in an estimated total revenue loss of \$1.75 billion, and \$926.8 million of this loss was "new."

**Table 10c**

<b>California State and Local Revenue Losses Due to E-Commerce, 2001 to 2011: Bruce/Fox 2001 (\$ millions)</b>		
	Total E-Commerce Loss	New
2001	\$1,750.0	\$926.8
2006	\$5,952.0	\$3,180.7
2011	\$7,225.0	\$3,842.2
Source: Bruce and Fox, University of Tennessee, Center for Business and Economic Research, September 2001.		

- A 2000 report by the U.S. General Accounting Office found the following estimates for combined state and local sales and use tax losses for all remote sales and for the Internet alone:<sup>79</sup>

**Table 10d**

<b>California Revenues Losses Due to Remote Sales, 2003: US GAO (\$ millions)</b>				
	Lower scenario		Higher scenario	
	All Remote	Internet	All Remote	Internet
2003	\$686	\$86	\$3,650	\$1,720
Source: U.S. General Accounting Office (GAO), 2000.				

- A 2000 study by the California Legislative Analyst Office estimated the potential total revenue loss to the state and to local governments in 1999 from B-to-C sales over the Internet at \$80 million to \$200 million.<sup>80</sup>
- A 2003 study by the Direct Marketing Association (DMA) estimated revenue losses due to e-commerce for the entire nation of \$2.5 billion in 2003. The DMA did not produce individual state estimates, but California's share of the national losses would be on the order of about \$350 million.

\* This calculation of the "new" revenue losses has been challenged by the Minnesota Sales Tax Gap study. They assert that the Bruce/Fox "assumption that 50 percent of the B-to-B revenue loss and 35 percent of the B-to-C revenue loss would have occurred even without e-commerce transactions, however, is speculative at best." Source: American Economics Group, Inc. *Minnesota Sales and Use Tax Gap Project: Final Report*, 2002, p. 48.

### ***Census Estimates for U.S. E-Commerce and Remote Sales***

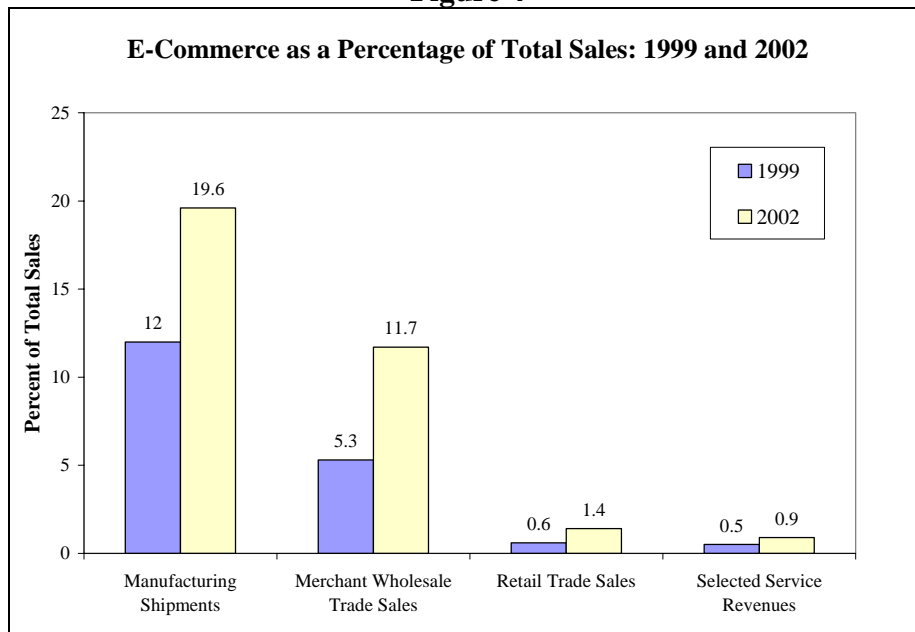
The U.S. Census Bureau started publishing separate e-commerce sales estimates for manufacturing, wholesale trade, retail trade and selected services in 1999. E-commerce includes sales of goods and services where an order is placed online by the buyer, or the price and terms of sale are negotiated online. Payment may or may not be made online. Ways to conduct e-commerce online include transactions over the Internet, extranet, Electronic Data Interchange (EDI), electronic mail, or other online system. The dominant position of e-commerce between businesses (B-to-B) reflects the long-standing use of EDI in manufacturing and wholesale trade. The EDI network exchanges computer-processable data in a standard format between organizational entities. EDI transactions are often conducted over proprietary networks, but can also be transmitted over open networks such as the Internet.

The dollar value of U.S. e-commerce activity, about \$1.157 trillion in 2002, varied significantly among key sectors in the economy (see Table 11). E-commerce represented a much larger share of total economic activity in sectors that sold primarily to other businesses. The percent distribution of e-commerce sales shows that B-to-B transactions accounted for 93 percent of overall e-commerce. As a percent of total sales in 2002, e-commerce represented almost 20 percent of manufacturing shipments and 12 percent of merchant wholesale trade sales, up about seven percentage points from their 1999 shares (see Figure 4). E-sales for selected services accounted for less than one percent of total sales in 2002. Four groups of services accounted for about half of total e-revenues in services: travel arrangement and reservation services; publishing; securities and commodity contracts intermediation and brokerage; and computer system design and related services. E-commerce retail sales, \$44 billion in 2002, accounted for 1.4 percent of total retail sales (\$3.2 trillion). The preliminary estimate of total retail e-sales for 2003 was \$56 billion, accounting for 1.6 percent of total retail sales (\$3.4 trillion).<sup>81</sup> Quarterly estimates for e-commerce retail sales are shown in Figure 5. During the Christmas season, there is a bump in e-sales.

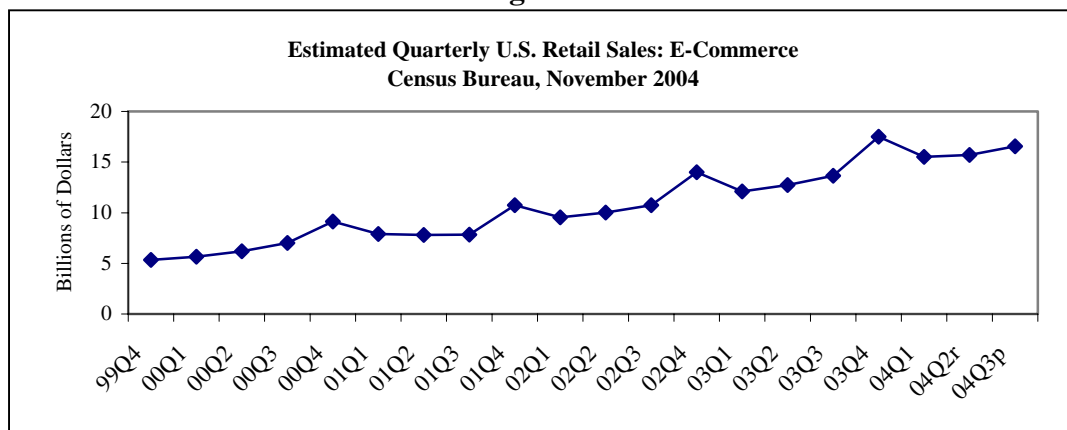
**Table 11**

<b>U.S. Shipments, Sales, Revenues and E-Commerce: 2002</b>				
Description	Value of Shipments, Sales or Revenue (\$ billions)		E-Commerce as Percent of Total Sales	Percent Distribution E-Commerce Sales
	Total	E-Commerce		
Total	14,675	1,157	7.9	100.0
B-to-B*	6,582	1,072	16.3	92.7
Manufacturing	3,840	752	19.6	65.0
Merchant Wholesale	2,742	320	11.7	27.7
B-to-C*	8,093	85	1.1	7.3
Retail	3,230	44	1.4	3.8
Selected Services	4,863	41	0.9	3.5
Source: U.S. Census Bureau, <i>E-stats: E-Commerce 2002 Highlights</i> , April 2004.				
*The B-to-B and B-to-C breakdown was estimated by the Census Bureau and was not directly measured.				

**Figure 4**



**Figure 5**



The percent distribution of e-commerce retail sales shows that over 90 percent of e-commerce retail sales are purchased from non-store retailers\* and motor vehicles and parts dealers, which are mostly car sales (see Table 12). Since cars are registered, sales tax is collected on these sales. The Census Bureau does not publish data for “remote sales.” To calculate “remote sales” relevant for use tax purposes, the most important Census series is “electronic shopping and mail-order houses (ESMOH),” a subsector of non-store retailers. The value of sales from electronic shopping and mail-order houses was \$114.5 billion in 2002, of which \$32.2 billion were e-sales and \$82.3 billion were traditional mail-order/catalog sales. A second component of “remote sales” is the e-

\* The category “non-store retailers” includes electronic shopping and mail-order houses (ESMOH), traditional auctions, door-to-door sales, sales from vending machines, and sales from portable stalls. ESMOH does not include most electronic auction sales: only sales from eMarketplaces that take title to the goods they sell are included. Auction commissions are included in ESMOH.

commerce portion of “other store retailers,” \$3.9 billion in 2002, which were mainly smaller companies that did not operate their electronic sales as separate business units. Total “remote sales” in 2002, then, were about \$118.4 billion (= \$3.9 + \$114.5 billion, see the italicized numbers in Table 12). Ignoring the small “other store retailers” adjustment, remote sales can be tracked fairly well using the ESMOH series alone.

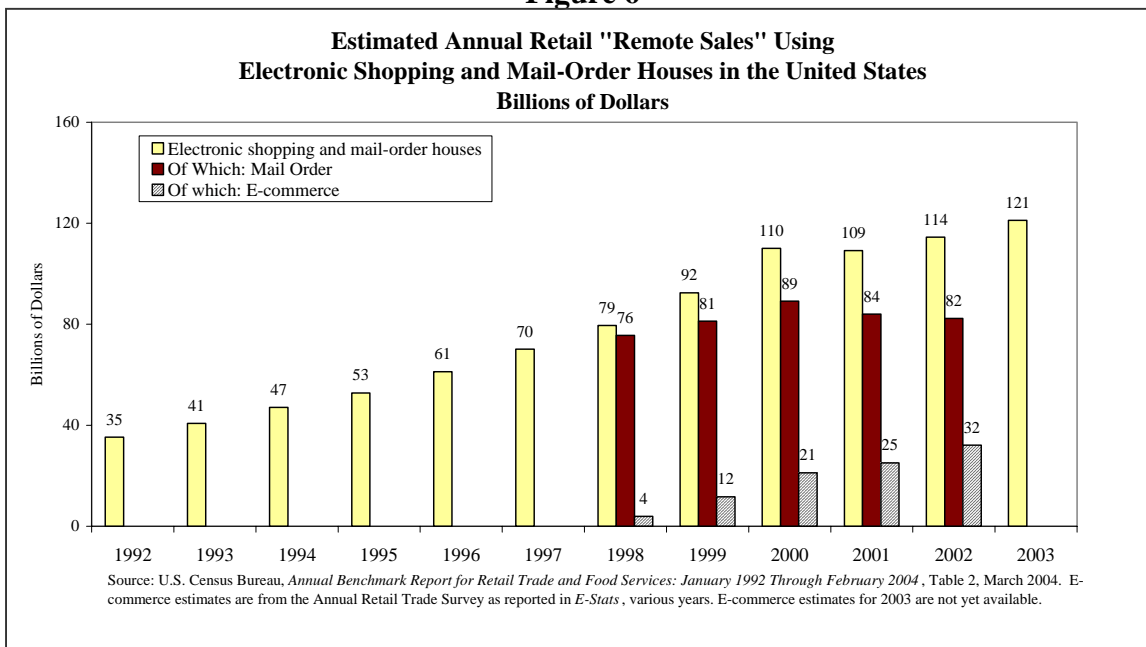
**Table 12**

<b>U.S. Retail Trade: Total and E-Commerce Sales: 2002</b>				
Description	Value of Sales (\$ millions)		E-commerce as Percent of Total Sales	Percent Distribution E-Commerce Sales
	Total	E-Commerce		
<b>Total Retail Trade</b>	<b>3,230,122</b>	<b>44,287</b>	<b>1.4</b>	<b>100.0</b>
Motor vehicles & parts dealers	846,248	7,231	0.9	16.3
Other store retailers*	2,206,610	3,939	0.2	8.9
Non-store retailers	177,264	33,117	18.7	74.8
Electronic shopping & mail-order houses (ESMOH)	<i>114,480</i>	32,191	28.1	72.7
Source: U.S. Census Bureau, 2002 Annual Retail Trade Survey, <i>2002 E-Commerce Multi-Sector Report</i> , Table 5.				
* Other store retailers include furniture, electronics, appliances, building materials, food, health, gasoline stations, clothing, sporting goods, books, music and miscellaneous store retailers.				

How fast have remote sales, and in particular e-sales, been growing? Over the past decade, retail sales from electronic shopping and mail-order houses (ESMOH) increased from \$35 billion in 1992 to \$114.5 billion in 2002 and \$121 billion in 2003 (see Figure 6). From 1998 to 2002, the e-commerce component of ESMOH sales increased rapidly, from 4 billion in 1998 to 32 billion in 2002. As a share of ESMOH sales, e-commerce has grown from five percent in 1998 to 28 percent in 2002. Since total ESMOH sales grew relatively slowly from 2000 to 2002, however, much of the recent rapid growth in e-purchases represented a shift from other types of remote sales (such as mail order) and not new remote sales. An example of a change in the composition of remote sales is when people who used to buy goods using catalogs (mail order) switched to Internet purchases. This change in composition is important because state and local government revenue losses due to uncollected use tax are based on total remote sales, which have been growing fairly slowly since 2000. Rapid growth in e-commerce does not necessarily imply rapidly growing state and local revenue losses from remote sales to the extent that e-commerce is replacing other forms of remote sales.

Detailed data for ESMOH sales show that e-commerce made up 28 percent of total sales in 2002 (see Table 13). For the following three categories of merchandise, e-commerce made up more than 40 percent of total sales: books & magazines, electronics & appliances, and office equipment & supplies. The percent distribution of e-commerce sales shows that the two merchandise groups with more than 10 percent of e-commerce sales were clothing & clothing accessories (including footwear) and computer hardware.

**Figure 6**



**Table 13**

U.S. Electronic Shopping and Mail-Order Houses: Total and E-Commerce Sales by Merchandise Line: 2002				
Description	Value of Sales (\$ millions)		E-Commerce as Percent of Total Sales	Percent Distribution E-Commerce Sales
	Total	E-Commerce		
Total Electronic shopping and mail-order houses	114,480	32,191	28.1	100.0
Books & magazines	4,017	1,848	46.0	5.7
Clothing & clothing accessories (includes footwear)	14,020	4,272	30.5	13.3
Computer hardware	21,203	5,873	27.7	18.2
Computer software	4,433	1,456	32.8	4.5
Drugs, health aids, & beauty aids	20,709	1,446	7.0	4.5
Electronics & appliances	4,419	2,030	45.9	6.3
Food, beer & wine	1,869	639	34.2	2.0
Furniture & home furnishings	7,116	2,447	34.4	7.6
Music & home videos	3,862	1,454	37.6	4.5
Office equipment & supplies	6,114	2,450	40.1	7.6
Sporting goods	2,687	910	33.9	2.8
Toys, hobby goods, & games	3,458	1,250	36.1	3.9
Other merchandise	15,651	3,858	24.7	12.0
Non merchandise receipts	4,922	2,258	45.9	7.0

Source: U.S. Census Bureau, 2002 Annual Retail Trade Survey, 2002 *E-Commerce Multi-Sector Report*, Table 6.

### *Forrester (Shop.org) Estimates for U.S. Online Retail Sales*

A second widely quoted source of information on trends in e-commerce is the annual Shop.org study of 150 retailers conducted by Forrester Research.<sup>82</sup> Shop.org is the online division of the National Retail Federation. Although “retail sales” are tracked by both Forrester and the Census Bureau,\* the term is defined more broadly by Forrester Research and includes services such as travel and auction gross merchandise sales.

According to [Shop.org](#), 2003 online retail sales jumped 51 percent to \$114 billion. Internet sales accounted for 3.8 percent of total non-travel retail and 5.4 percent of all retail sales. These numbers differ substantially from Census Bureau estimates, so it is important to keep in mind the differences in definitions (see Table 14). In 2003, Census Bureau e-commerce retail sales grew 26 percent to \$56 billion and accounted for 1.6 percent of total retail sales.

**Table 14**

<b>Comparison of Estimates for Electronic “Retail Sales” 2001 to 2004</b>						
	Shop.org, Forrester Research			Census Bureau E-Commerce		
	Online Retail Sales (\$ Billions)	Annual Growth	Percent of Total Retail Sales	E-Commerce Retail Sales (\$ Billions)	Annual Growth	Percent of Total Retail Sales
2001	\$51.3			\$34.3	23%	1.1%
2002	\$75.7	48%		\$44.3	29%	1.4%
2003	\$114.1	51%	5.4%	\$56.0	26%	1.6%
2004p	\$144.6	27%	6.6%			
Source: Shop.Org data - <i>Sacramento Bee</i> , June 8, 2004 Section D. According to Forrester’s definition, retail sales include: sporting goods and equipment; flowers, cards and gifts; health and beauty; travel, consumer electronics; other (subscriptions, art and collectibles); apparel; jewelry and luxury goods; home; food and beverage; books; tickets; computer hardware and software; music and video; toys and video games; auctions; auto and auto parts. U.S. Census Bureau, E-Commerce Multi-Sector Historical Data Tables.						

Travel revenue accounts for a large part of the difference between these estimates. According to [Shop.org](#), more than a third of online retail sales were travel-related and travel was one of the online product categories with the strongest growth in 2003 (91 percent). The Census Bureau includes e-commerce estimates for travel in services, not in retail sales (see Table 15). According to 2002 Census Bureau data, travel accounted for 15.4 percent (= 6.4 / 41) of B-to-C e-commerce revenue for selected services and 7.5 percent (= 6.4 / 85) of total B-to-C e-commerce. About 24 percent of travel service

\* The Census Bureau category “retail sales” does not include services such as travel (see Tables 11, 12, 13; Figures 4, 5 and 6). Census Bureau data for retail sales are measured using the Annual Retail Trade Survey (ARTS), which collects data annually from approximately 19,000 firms with paid employees. Sales for firms without paid employees are estimated using administrative records. The retail trade universe contains approximately 2.5 million firms. For services such as travel, the Census Bureau uses the Service Annual Survey (SAS), which has an annual sample of 58,000 firms representing the universe of three million establishments. The SAS measures activity of employer firms classified in nine service-related sectors. The report does not include approximately one-third of service-related industries.

revenue was e-commerce (= 6.4 / 26.5). E-commerce travel revenues increased only two percent between 2001 and 2002.

**Table 15**

<b>2002 Census Bureau Estimates for Travel Services (\$ billions)</b>		
	Total	E-Commerce
Total B-to-C	8,093	85
Retail Sales	3,230	44
Selected Services	4,863	41
<i>Travel Arrangement and Reservation Services</i>	26.5	6.4

The Shop.org study provides detailed information on profitability that is not collected in Census Bureau surveys. Internet retailers on the whole managed to break even for the first time in 2002 and turned an average operating profit of 21 percent in 2003. While merchants that sell exclusively online enjoyed the biggest boost in profits, they remained less profitable in general than stores with a physical outlet. Cataloguers said their profit margins averaged 28 percent. A greater number of retailers were moving towards becoming profitable: 79 percent of all online retailers were profitable in 2003, up from 70 percent in 2002.

In July 2004, Forrester released a study on the growth of multi-channel retailing that included projections for business-to-consumer e-commerce sales. Fueled by a steady stream of new online shoppers and new product category sales, Forrester projects U.S. e-commerce will grow at a 19 percent annual growth rate from 2003 to 2008. Online retail will reach nearly \$230 billion by 2008 and account for 10 percent of total retail sales, which include store, Internet and mail-order sales. To forecast future online sales, Forrester estimates the percentage of individual product categories that will move online using a hyper-growth statistical model that calculates how long it will take for each category to reach varying degrees of online penetration.

### ***National Projections of Revenue Losses From E-Commerce Sales***

On a national level, examples of two studies with varying revenue loss estimates are the 2004 study by Professors Donald Bruce and William Fox of the University of Tennessee's Center for Business and Research (the "Bruce/Fox study") and the 2003 study by Dr. Peter A. Johnson, a Senior Economist with the Direct Marketing Association (the "DMA study"). The DMA projected state and local government losses ranging from \$2.5 billion in 2003 to \$3.7 billion in 2008. According to the Bruce/Fox report, however, losses ranged from \$15.5 and \$16.1 billion in 2003 to \$21.5 and \$33.7 billion in 2008.

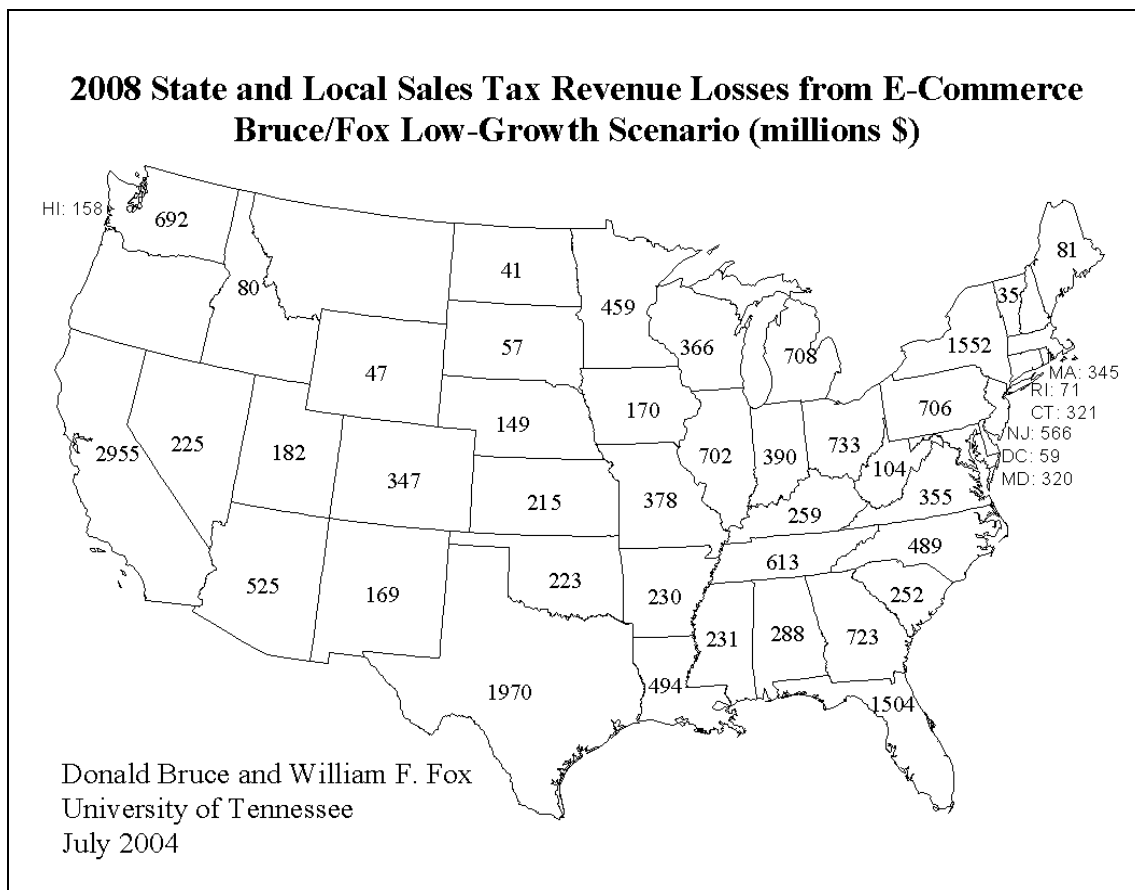
The Bruce/Fox study was commissioned by the National Governors Association and the National Conference of State Legislatures. It relies upon proprietary projections from Forrester Research, a private consulting group. The 2004 Bruce/Fox estimates are revisions of 2001 estimates that projected much higher losses, \$26.2 billion in 2003 and \$50.4 billion in 2008.

Compared with their 2001 study, the 2004 Bruce/Fox revenue loss projections are lower because:

1. U.S. Census data suggest that e-commerce has grown more slowly from 1999 to 2002 than originally forecast, so growth assumptions were scaled back, and
2. Use tax compliance estimates are higher than originally forecast. More vendors are collecting tax as they merge their online and offline sales channels. The DMA report describes this type of merging as “the demise of the pure-play ‘e-tailer’ model in favor of ‘bricks and clicks’ multi-channel marketing.”<sup>83</sup>

The 2004 Bruce/Fox study provides state-level loss estimates by allocating national losses based on the breadth, level and growth of each state’s tax base as well as its tax rate. The use of general assumptions for each state is an approximation. California’s share of the national state and local losses was 13.8 percent (13 percent for state and 17.1 percent for local). Figure 7 shows the Bruce/Fox study estimates of state and local revenue losses in 2008. Relative to total tax revenues, losses were highest in states that rely most heavily on the sales tax as a revenue source such as Texas, Tennessee, Florida, Nevada, Arizona, Mississippi and Washington.

**Figure 7**



Figures 8a, 8b and 9 compare 1999 to 2002 U.S. Census Bureau e-commerce estimates with sales projections by Bruce/Fox and the DMA. The projections differ along several dimensions: what is included in the base year, growth rate projections, the percentage of the sales that are taxable, and use tax compliance. Further discussion of the assumptions behind these estimates is included in Tables 17a and 17b. For the B-to-B projections, Bruce and Fox estimated two scenarios: the low-growth scenario, which assumed the same rate of growth as Congressional Budget Office forecasts for nominal GDP, and the high-growth rate scenario, which assumed that B-to-B represents the same percentage of total e-commerce transactions in each year as the Forrester forecast in the Bruce/Fox 2001 study. Estimates of revenue losses due to e-commerce sales have three basic steps:

1. estimate sales;
2. calculate the taxability of sales;
3. estimate the extent to which e-commerce sellers and purchasers already pay tax (i.e. estimate compliance).

#### Projections of E-Commerce Sales:

- For B-to-B baseline sales estimates, the DMA and Bruce/Fox low-growth scenario project that the B-to-B base will increase along the same, fairly slow-growth path that the 1999-2002 Census figures followed (see Figure 8a, “B-to-B base sales LOW”). The Bruce/Fox B-to-B high-growth base estimates have the same starting point in 2003 as the low-growth estimates, but are projected to increase at a much higher annual growth rate (see Figure 8b, “B-to-B base sales HIGH”).
- For B-to-C, the DMA base is narrower than the Census B-to-C estimate because the DMA excludes sales from selected services from its baseline estimate. The Bruce/Fox base estimates are of the same magnitude as the Census base, but use a higher growth rate for projections than the DMA (see Figure 9, “B-to-C base sales”).

#### Taxability and Compliance:

B-to-B and B-to-C e-commerce sales include many transactions that are exempt from tax or not taxable. The extent to which purchasers already comply must also be taken into account. E-commerce sales resulting in revenue loss are used to calculate potential sales tax losses from e-commerce (see Figures 8a, 8b and 9, “Sales Resulting in Loss”).

- The DMA’s calculation of B-to-B sales resulting in revenue loss excludes most EDI transactions because the DMA assumes tax is already being collected on EDI. As a result, the DMA’s estimate of B-to-B sales resulting in revenue loss is very small. The Bruce/Fox estimates, on the other hand, assume lower compliance for EDI sales. After making adjustments for transactions that are exempt from tax, the Bruce/Fox study has substantial B-to-B sales resulting in revenue loss.
- For B-to-C sales, both the DMA and Bruce/Fox included about the same proportion of sales (80 percent) to calculate sales resulting in revenue loss, but from different bases.

Figure 8a

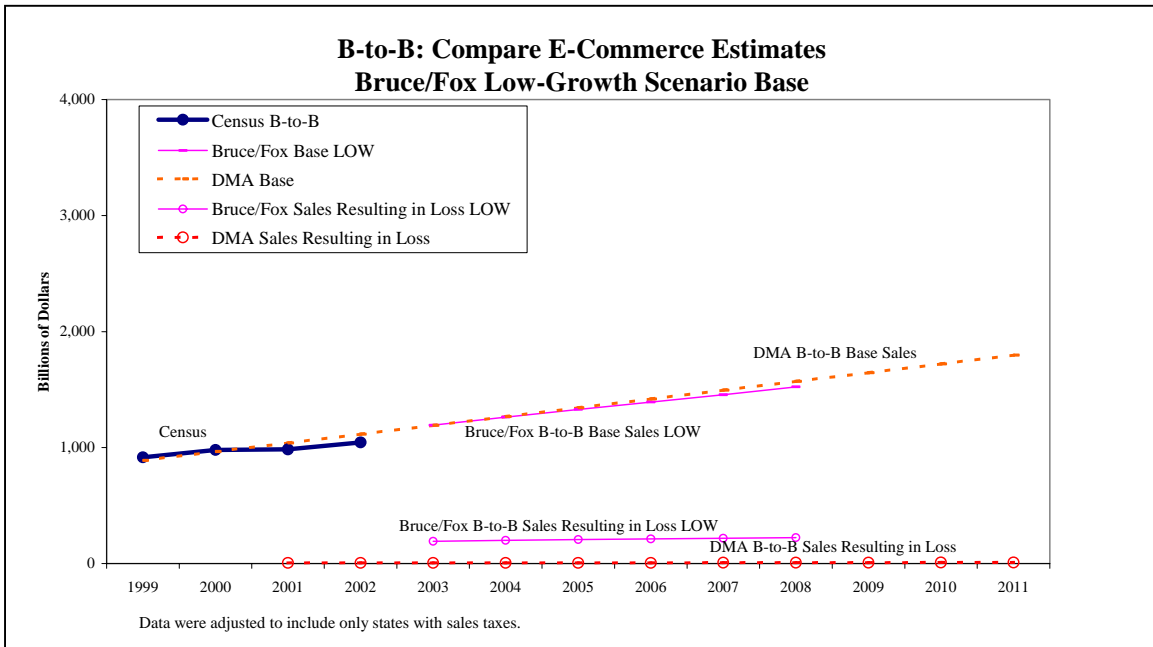
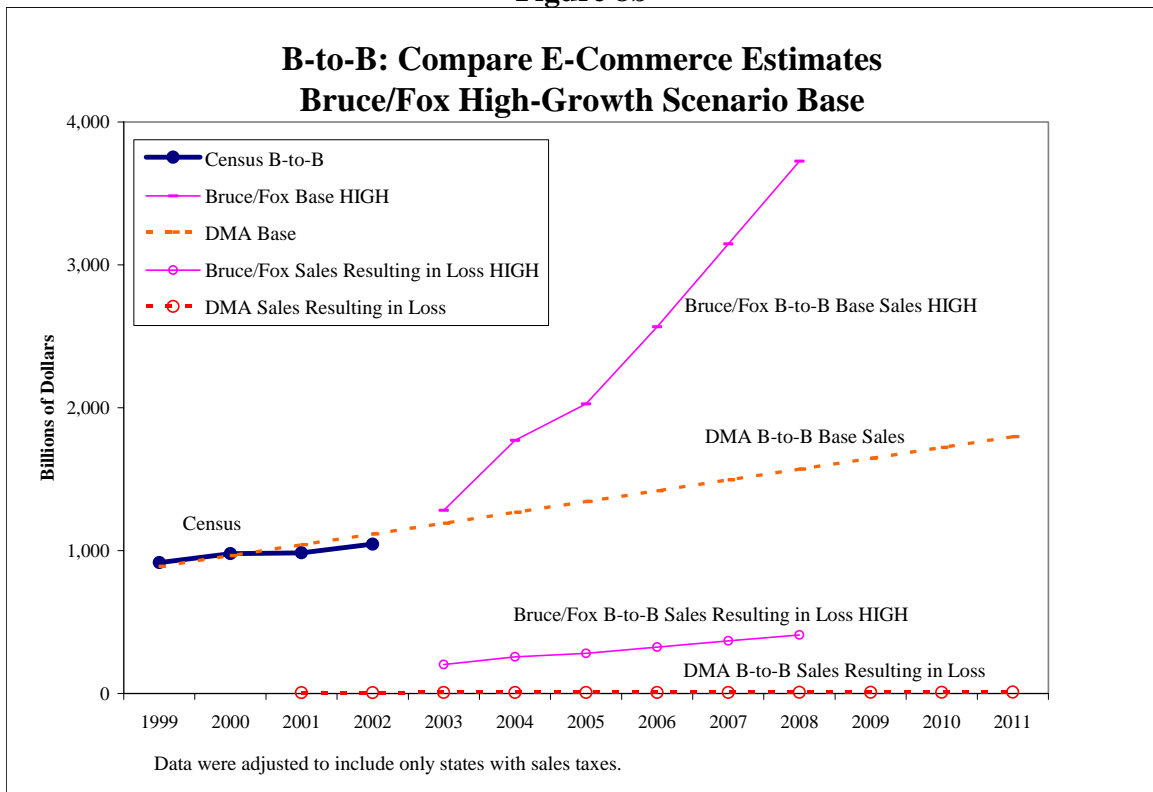
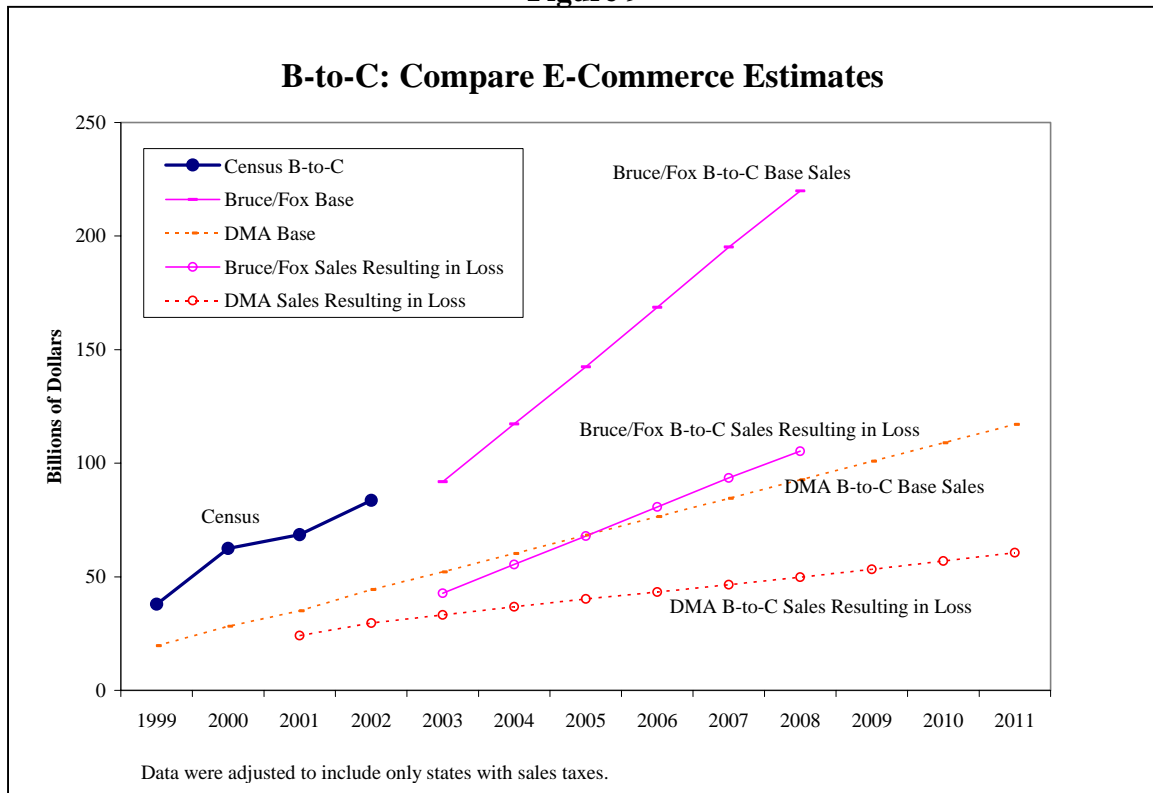


Figure 8b



**Figure 9**



### ***Methodological Differences: Bruce/Fox, DMA and BOE***

There is a wide range of opinions regarding use tax compliance of business purchasers. The assumptions concerning electronic data interface (EDI) account for a large part of differences in these revenue loss estimates: the DMA study assumed that states already receive most of the tax revenue relating to EDI transactions so they excluded most B-to-B transactions from their loss calculations; the Bruce/Fox study, on the other hand, included in its measure of e-commerce a non-negligible percentage of B-to-B transactions conducted via EDI.<sup>84</sup> Clearly, more research needs to be done on this topic. In the view of the DMA report: “Although the typical 98 percent of use tax remittances derived from business sources strongly suggests a very high compliance rate, it is only appropriate to acknowledge that solid empirical research on the question of business use tax compliance rates remains to be done. Neither the Tennessee authors nor any other scholars appear to have moved beyond the level of educated guesswork on this issue.”<sup>85</sup>

EDI transactions are important in revenue loss calculations but data are inadequate. The dominant position of B-to-B transactions in e-commerce reflects the long-standing use of EDI in both manufacturing and wholesale trade. The Census Bureau began publishing estimates of EDI transactions for merchant wholesalers in 2000 (see Table 16). Although manufacturers also have a long history of EDI use, separate EDI estimates for manufacturers have not been published by the Census Bureau. In 2002, EDI sales for merchant wholesalers totaled \$275 billion and accounted for 86 percent of their e-commerce sales.

**Table 16**

<b>Merchant Wholesale B-to-B Sales: EDI as a Percent of E-Commerce</b> (\$ Billions)				
	Total Merchant Wholesale B-to-B Sales	EDI	E-Commerce	EDI as % of E-Commerce
2000	\$2,743.6	\$216.8	\$248.4	87%
2001	\$2,701.5	\$247.9	\$286.2	87%
2002	\$2,742.3	\$275.1	\$319.8	86%
Source: U.S. Department of Commerce, Census Bureau, <i>E-Stats</i> , April 15, 2004. Tables 2 and 3.				

In January 2003, the Washington State Department of Revenue released a study showing a sharp drop in use tax compliance among businesses. In the 2003 study, registered businesses failed to pay 27.9 percent of use taxes due on out-of-state purchases, up from the 19.9 percent found in a 1996 study.\* One possible explanation is that the expansion of e-commerce was prompting more businesses to buy items from out of state.<sup>86</sup>

Table 17a compares assumptions for the taxability of sales and for use tax compliance rates for various revenue loss studies, including estimates from the California Board of Equalization (BOE). Higher revenue losses from uncollected use tax result from a higher percentage of sales that are taxable (i.e. the lower the percentage of sales that are tax exempt) and/or a lower compliance rate.

**Table 17a**

<b>Methodology: Taxability and Compliance Assumptions in Revenue Loss Estimates</b>		
	B-to-B	B-to-C
Percentage of Taxable Sales (percent not exempt from tax)		
Ca. BOE 2002, 2004	57.5% (2001, 2003)	95% (2001, 2003)
Bruce/Fox 2001	60% (2001) => 37% (2011)	91% (2001) => 83% (2011)
Bruce/Fox 2004	56% (2003) => 41% (2008)	80% (2003 => 2008)
DMA 2003	60% (2001) => 37% (2011)	86% (2001) => 78% (2011)
U.S. GAO 2000	Different assumptions by product category.	94 to 100%
Use Tax Compliance Rates		
Ca. BOE 2002, 2004	80% (2001, 2003)	50% nexus (2001, 2003)
Bruce/Fox 2001	65.2% <sup>†</sup> (2001 => 2011)	19% (2001) => 28% (2011)
Bruce/Fox 2004	72 to 73% <sup>‡</sup> (2003 => 2008)	40 %
DMA 2003	85% (2001 => 2011)	20% (2001) => 34% (2011)
U.S. GAO 2000	85 to 100% (autos) 50 to 95% (all other products)	Different assumptions by product category.

\* The 2003 study used a stratified random sample of audits completed between 1997 and 2000. Assessments were annualized to a single year and statistically projected to calendar year 1998.

<sup>†</sup> The Bruce/Fox 65.2% compliance rate for B-to-B was a weighted average of 50% compliance for non-vehicle purchases and 100% compliance for vehicle purchases.

<sup>‡</sup> According to Professor Fox, the 72 percent compliance rate is based on the Washington State Department of Revenue Compliance Study (2003), which found that in 2003 registered businesses in Washington failed to pay 27.9 percent of use taxes due on out-of-state purchases.

Despite large differences in revenue loss estimates, the rates used in the DMA and the Bruce/Fox studies were in many cases not all that different (see Table 17a). The large differences between “base sales” and “sales resulting in loss” in Figures 8 and 9 are due to not only differences in rates, but also to adjustments to the base by the DMA before the rates were applied to census data. Table 17b shows the adjustments to E-Stats Census data used by the DMA and also by the California BOE. Adjustments to B-to-B sales were to exclude interplant sales as well as EDI transactions. Using 2002 as an example, the DMA included only five percent of the total \$752 billion in B-to-B e-commerce manufacturing and 12 percent of merchandise wholesale e-commerce. The BOE loss calculations included all manufacturing sales but omitted merchant wholesale trade sales. Both the DMA and the BOE excluded services from the B-to-C calculation of base sales. Since the BOE loss estimates were for all remote sales and not just e-commerce, mail order sales were also included in BOE loss calculations.

**Table 17b**

<b>Methodology: Adjustments to E-Commerce Census Data for EDI, Interplant Sales and Services</b>					
	Remote Sales				
	E-Commerce: B-to-B		E-Commerce: B-to-C		Mail Order
	Manufacturing	Merchandise Wholesale	Retail Sales	Selected Services	
U.S. Dept. Commerce (Census): <i>E-Stats</i> 2002	\$752 billion	\$320 billion	\$44.3 billion	\$41 billion	\$82.3 billion
<i>Percent of Total Internet Commerce Base Sales Included in DMA Calculation</i>					
DMA 2003	5%	12%	100%	0%	NA
<i>Percent of Total Remote Base Sales Included in BOE Calculation</i>					
California BOE 2003	100%	0%	84%*	0%	100%
CA share of US sales	12%		12%		10%
*E-commerce auto sales were omitted by the BOE.					

A final methodological comment concerns the BOE’s estimate of a 50 percent use tax compliance rate for B-to-C remote sales (see Table 17a). This was derived by assuming that 50 percent of B-to-C sales were from firms with California nexus, and those firms were 100 percent compliant. The 50 percent nexus assumption is most likely higher than in other states and is based on a 1985 BOE study, but the BOE believes the factors responsible for greater California nexus remain the same today.<sup>87</sup> These are: (1) A greater-than-average proportion of transactions by the state’s consumers is made with companies located in California because the state has such a large share of the nation’s population, and (2) the California BOE more aggressively enforces nexus compliance than most states. California has out-of-state field offices for sales tax collection in Chicago, Houston and New York, for example. **The legislature might want to request the BOE to make a more current estimate of the percentage of B-to-C sales from firms with California nexus, because it is important in revenue impact calculations as well as in calculations of the gains or losses from conforming to the SSUTA.**

## ESTIMATED REVENUE GAIN/LOSS FROM CONFORMING TO THE SSUTA

For California, potential revenue gains/losses from conforming to the Streamlined Sales and Use Tax Agreement have not been estimated. To estimate the potential gains, the Board of Equalization (BOE) would need to consider the revenue impacts of all provisions of the SSUTA that differ from current California law as well as the cost of implementing new procedures, databases and systems (see Tables 2, 3, 6, 7, 8 and 9). Since revenue impacts will partially depend on choices made by the legislature as to how to conform to SSUTA definitions, various scenarios will need to be provided.

Calculations of revenue gains and losses from conforming to the SSUTA in other states use varying methodologies. The short-term effects of SSUTA compliance on revenues in the next fiscal year can be estimated as well as the long-term effects. Some states address uncollected use tax that might be collected and other states do not. Often states point out that the uncollected use tax is actually imposed on purchasers under current law. Compliance with the SSUTA wouldn't increase the tax imposed; it just allows collection by a seller rather than remittance by the customer.

In Wisconsin, an estimate of use tax that currently goes uncollected is about \$150 million.<sup>88</sup> Conforming to the SSUTA is estimated to produce a net loss of \$5.37 million dollars from the state sales tax and an additional \$390,000 net loss from county and stadium taxes in fiscal year 2005. Most of the losses are due to lower revenues from the taxation of food and durable medical equipment for home use. Counterbalancing these losses, the state will realize an estimated \$2.17 million increase in state and local sales taxes due to voluntary collections by large multi-state retailers.\* Wisconsin also anticipates administrative costs related to the Agreement of \$25,000.<sup>89</sup>

A January 2004 report for the state of Washington, "Streamlined Sales and Use Tax Agreement Sourcing Study," provided estimated revenue gains from conforming sales tax laws to the SSUTA. "The Department [of Revenue] estimates that the State will realize \$2.2 million in new revenue for the '03-'05 biennium and \$10.2 million for the '05-'07 biennium from becoming a member state of the [SSUTA]."<sup>90</sup> The Department estimated that in 2002, \$3.1 billion in remote sales were untaxed, a loss of about \$59 million in tax for all local taxing jurisdictions and \$200 million for state government.<sup>91</sup> The Department has estimated that the loss of retail state and local sales/use tax revenues will grow to \$493 million in 2005 as a result of tax-free sales made by remote sellers.<sup>92</sup>

In Texas, other than the sourcing provisions, changes to the tax code to comply with the SSUTA would not make substantial changes to the way in which most state and local sales and use taxes are collected and administered. In Spring 2003, the Legislative Budget Board estimated a positive impact on the General Fund of \$3.36 million through the biennium ending August 31, 2005 (see Table 18). With regard to Internet transactions, the SSUTA is expected to simplify tax collection procedures for retailers that currently do not remit tax for sales conducted over the Internet. This would

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\* In anticipation of the Agreement, several national retailers voluntarily began collecting and remitting sales taxes to 38 states, including Wisconsin but not California, in February 2003.

encourage some retailers to begin collecting and remitting tax, and would have a positive effect on sales tax revenues. For local units of government, the proposed changes related to the sourcing of transactions could result in a shift of revenues between jurisdictions but would not significantly affect total collections. The Texas Comptroller is required to conduct a study of the costs to political subdivisions of changing sourcing laws.<sup>93</sup>

**Table 18**

<b>Texas: Projected 5-Year Fiscal Impact of Complying with the SSUTA</b> (Thousands of dollars)				
<b>Fiscal Year</b>	<b>Probable Revenue Gain/(Loss) From GENERAL REVENUE FUND</b>	<b>Probable Revenue Gain/(Loss) From Cities</b>	<b>Probable Revenue Gain/(Loss) From Transit Authorities</b>	<b>Probable Revenue Gain/(Loss) From Counties/Special Districts</b>
2004	\$1,489	\$247	\$89	\$31
2005	\$1,871	\$344	\$124	\$43
2006	\$1,955	\$360	\$130	\$45
2007	\$2,038	\$375	\$135	\$47
2008	\$2,123	\$391	\$141	\$49

Source: Texas, Legislative Budget Board, Fiscal Note, 78<sup>th</sup> Regular Session, 2003, SB823 & HB3143.

The changes stemming from Ohio's participation in the SSTP are estimated to cost the state about \$21 million in lost revenue over fiscal year 2004-05, but Ohio hopes to recapture the money when out-of-state retailers either volunteer or are required by the federal government to collect state sales tax.<sup>94</sup>

For Florida, legislative analysts predicted initial implementation of the SSUTA would be revenue neutral. Florida would lose tax revenue at first as a result of reclassifying candy, fruit drinks and medical exemptions to conform with the SSUTA uniform sales tax code, but would offset the losses by acquiring new taxing authority on shipping costs. If Internet and mail-order transactions were taxed more reliably, overall tax revenue would be expected to climb as greater numbers of cyber-merchants actually begin collecting and remitting Florida's six percent state sales tax. Implementation of the SSUTA should improve the Florida sales and use tax by significantly reducing the costs of collecting and remitting state and local sales taxes. As of early March 2004, legislation that would bring Florida's tax code into compliance was advancing in the Senate, but encountered opposition in the House. House Speaker Johnnie Byrd opposed the measures because he believed the additional sales tax revenue they would generate from catalog and Internet-based transactions would contribute to government growth, an expectation that contradicts his "less taxes, smaller government" campaign promises.<sup>95</sup>

In Michigan, changes to the sales and use tax bases, dealing primarily with the adoption of uniform definitions, would reduce revenue by an estimated \$18.3 million (\$17 million in sales tax and \$1.3 million in use tax) in fiscal 2005. These changes were scheduled to take effect on September 1, 2004. The largest fiscal effect will come from the elimination of the sales tax on "deli trays" – a change due to an altered definition of what is considered to be "prepared food" (taxed) and "unprepared food" (not taxed). Michigan, however, expects to more than make up for the \$18.3 million loss from

additional sales and use taxes collected due to increased voluntary compliance. The Michigan Department of Treasury estimates that uncollected revenue on remote sales is about \$258 million in fiscal 2005. If the state were to collect about seven percent of the \$258 million it is currently not collecting, it would make up the \$18.3 million loss. Although the sales tax streamlining process is commonly viewed as directed at Internet commerce, the Department of Revenue has noted that of the \$258 million in lost revenue, only about \$93 million is estimated to be from Internet (electronic commerce) sales; \$160 million comes from sales via catalog and other remote purchases.<sup>96</sup>

Chicago's October 2004 Civic Federation study calculated the potential costs and benefits if Illinois had joined the SSUTA in 2002.<sup>97</sup> The study did not include projections. Increased revenues from the taxation of remote sales would have amounted to \$101 million in 2002 but the potential costs were \$396 million. The net fiscal impact in the first year would have been -\$295 million, but most of this was due to one-time costs (of \$244 million due to a one-year delay in the collection of taxes on lease payments) and revenue shifts due to destination-based sourcing. Costs in the second year of the Agreement would have been much lower.

## **CALIFORNIA EFFORTS TO COLLECT MORE USE TAX**

Instead of joining the SSUTA, could California improve use tax collection? The inability to enforce use tax collection for out-of-state vendors or in-state purchasers is a vexing problem for state revenue departments. Recall that the use tax is not a new tax (it was enacted in 1935) and is not a tax on the Internet. The use tax law was intended to eliminate the competitive advantage of out-of-state retailers not required to pay sales tax.

California's ability to collect use tax on products purchased out-of-state for storage, use, or consumption in-state is hampered by several challenges:

1. Most in-state purchasers of out-of-state products are ignorant of their use tax liabilities.
2. Many in-state purchasers of out-of-state products who are aware of their use tax liabilities choose not to self-report their use tax liabilities, because they believe that the state will not pursue them.
3. Many out-of-state companies structure their operations in such a way as to legally avoid the requirement to register with the BOE and collect use tax from their customers on behalf of California.
4. Some out-of-state companies doing business in California fail to register with the BOE in violation of state law.

Any company that has physical presence (nexus) in California is required to collect sales tax on all purchases made by Californians, whether in the store, over the Internet or through catalog sales. The Gap, for example, collects sales tax on Internet purchases made through the company's web site. Companies such as Barnes & Noble, however, have organized their brick-and-mortar stores and their remote retailers into separate subsidiaries in an attempt to avoid collecting sales tax on mail order and Internet

purchases. Although some out-of-state businesses collect California use tax and pay it to the state, many out-of-state businesses do not. The three types of use tax assessment are:

1. individuals (art, jewelry, cigarettes, etc.),
2. businesses with a seller's permit (these businesses are registered with the BOE), and
3. businesses without a seller's permit (service enterprises such as hotels and dentists that are not registered with the BOE but are likely to purchase equipment from out-of-state retailers)

For use tax collection, the BOE generally follows up only on businesses with seller's permits to determine whether an out-of-state seller should pay use tax liabilities. For individuals, use tax is currently collected for some goods, such as those that must be registered with the state (boats and motor vehicles, for example). For most transactions subject to use tax, it would not be cost effective to audit individuals. One exception is customers of out-of-state art galleries who had their artwork shipped into California. In early 2004, California auditors caught the attention of taxpayers by sending out letters or making personal visits to inquire whether use tax had been paid on out-of-state art purchases.<sup>98</sup> A second exception is cigarette purchases over the Internet.

For fiscal year 2001-02, the BOE estimates that tax evasion due to cigarette purchases online cost the state about \$21.5 million in use tax revenue; losses due to all remote cigarette sales by consumers were about \$54 million.<sup>99</sup> In addition, cigarette tax evasion by retailers was estimated at \$238 million, for a total cigarette tax evasion estimate of \$292 million in FY 2001-02.\* Nationally, the major tobacco companies and the states' attorney generals are supporting bipartisan legislation in Congress designed to ensure the collection of taxes on online tobacco sellers.† Because of the federal government's inability to enforce federal laws against cigarette smuggling, Big Tobacco (Phillip Morris, R.J. Reynolds, Brown & Williamson, and Lorillard) is facing a steady erosion of its market share from Little Tobacco – hundreds of small tobacco companies that sell cigarettes and other tobacco products over the Internet. The small companies are able to sell packs at a substantially lower price than packs from Big Tobacco because the smaller companies are not party to the tobacco master settlement agreement. Unless the erosion can be stemmed and states are granted greater enforcement and taxing authority, Big Tobacco's profits and tobacco payments to the states could decrease. This, in turn, could perhaps even threaten to strain the burgeoning tax-exempt bonds and credit ratings of states that have become dependent on the master settlement payments.<sup>100</sup>

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\* According to the BOE, "cigarette tax evasion by retailers is organized or systematic evasion, primarily by retailers who knowingly purchase contraband cigarettes. Consumers who purchase these contraband cigarettes do so unwittingly. They believe they are paying all excise taxes due." Ca. State Board of Equalization. *Documentation of BOE 2003 Cigarette Tax Revenue Evasion Estimates*, February 25, 2003.

† HR 2824, the Internet Tobacco Sales Enforcement Act. S 1177 "Prevent All Cigarette Trafficking Act," passed by voice vote in December 2003. The Senate bill would enhance the Jenkins Act (Public Law 81-363), the 1949 federal law that requires cigarette vendors to file reports on their sales with state tax administrators by permitting state and local officials to sue cigarette distributors in federal court for violating the law. Under current state law, only the federal government can sue, but according to the General Accounting Office, it rarely does. Senate bill 1177 does not mandate Internet tobacco vendors to remit sales (use) taxes on their online sales.

To collect use tax from individuals, the state has a choice: either ask people to keep track of actual receipts from out-of-state purchases or use a table calculation (estimate use tax as some percentage of sales taxes and charge everyone the same percentage). States generally ask people to keep track of their receipts. Maine is one state that implemented a table calculation (a “default assessment” of 0.04 percent of adjusted gross income if the line was left blank) when the line was added to tax forms in 1989. By 1998, the default assessment was ended because of concerns the system wasn’t fair for taxpayers who simply forgot or didn’t know the rules.<sup>101</sup>

Over the past several years, the BOE has been making a concerted effort to raise public awareness of the use tax and increase revenue collection.<sup>102</sup> For example:

- A use tax form was included in the state’s 2002 Personal Income Tax Booklets for the purpose of reporting use tax.
- In 2003, legislation (SB 1009) was passed authorizing the addition of a fill-in line on the personal income tax form for use tax reporting. The revenues were collected initially by the California Franchise Tax Board (FTB) and then were forwarded to the Board of Equalization (BOE).\*
- Effective January 1, 2004, the In-State Voluntary Disclosure Program (Revenue and Taxation Code section 6487.06) allows purchasers within California, who are not otherwise required to hold a seller’s permit, to report and pay their use tax liability within a three-year statute of limitations.<sup>103</sup> The three-year limitation is beneficial to taxpayers because otherwise the applicable statutory period would be eight years. The Board is also allowed to waive late filing and penalty fees.

The migration of the California use tax over to the 2003 income tax return, which was referred to as a “cross-species merger” in a recent *State Tax Notes* article, was cited as part of a “whole new dimension” facing California income tax payers.<sup>104</sup> As of March 2004, 20 states had a voluntary use tax line on their income tax form.<sup>†</sup> Two possibilities for the use tax line are the fill-in line (used by California) or the yes/no line.<sup>‡</sup> Concerning the choice between a yes/no line and a fill-in line, the experience of Michigan is instructive: In 1998, Michigan had a yes/no line and collected \$240,000 from 3,000 returns. In 1999, Michigan changed to a fill-in line and collected \$2.9 million from 64,650 returns. In 2000, \$3.1 million was collected from 80,150 returns.<sup>105</sup>

For 2003, the BOE projected the out-of-state sales line on the income tax return would raise \$13 million, out of an estimated \$1.2 billion in use tax owed by individuals and

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\* Both BOE and FTB anticipated significant administrative costs to implement and administer use tax collection. The 2003-04 Budget Bill included \$2.228 million for these expenses.

† The 20 states include: Alabama, California, Connecticut, Idaho, Indiana, Kentucky, Louisiana, Maine, Massachusetts, Michigan, New Jersey, New York, North Carolina, Ohio, Rhode Island, South Carolina, Utah, Vermont, Virginia, and Wisconsin, according to the Federation of Tax Administrators. Georgia, Hawaii, and the District of Columbia have separate forms in the income tax packages. (See Michael Gormley, “States Bent on Collecting Internet Taxes,” *Associated Press*, March 4, 2004).

‡ Using a yes/no line, the respondent answers “yes” or “no” to the following type of statement: “In 2003, I purchased items from an out-of-state or Internet retailer without paying California sales or use tax.” If the answer is yes, the respondent would need to fill out a totally separate form and mail it to the BOE.

businesses.<sup>106</sup> The BOE based its \$13 million use tax revenue estimate on an average compliance rate in 10 other states of 0.8 percent among eligible taxpayers.\* As of August 2004, the state had collected only \$1.3 million in use tax revenue. Out of the 12,527,383 individual income tax returns processed, only 20,324 returns included use tax payments. By October 2004, use tax revenue from extension filers increased the total collected to \$2 million.<sup>107</sup> The cost to add the use tax line item to the forms and process the receipts was about \$1 million in 2003, but is expected to decrease to \$237,000 in subsequent years.<sup>108</sup>

Like California, New York added a line on its income tax for voluntary use tax assessment in 2003, but many taxpayers have already complained and a New York lawmaker has introduced a bill to drop the line. “We’re going to make tax evaders out of law-abiding citizens and policemen out of tax preparers and accountants,” said Assemblyman Ronald Tocci. “Who,” he asked, “keeps tabs of what they buy on vacation in the Bahamas or Canada? Or any place? It’s crazy. It’s insane.”<sup>109</sup> As of July 2004, about four percent of processed New York returns reported any use tax amount, which is considered a relatively good result for the first year of inserting such a line on a return. New York has also pursued purchasers of big-ticket items such as art, jewelry, antiques and furs. About 210 art purchasers paid \$26 million in recent years as a result.<sup>110</sup>

The BOE is pursuing companies with nexus in California. An example is the BOE full-scale nexus audit of Barnes & Noble Dot Com.<sup>111</sup> Details concerning the BOE decisions in Barnes & Noble Dot Com and Borders Online are described in the October 2003 issue of *Western City* article, “Leveling the Playing Field Between Main Street and Out-of-State Retailers,” by Carole Migden, who was BOE Chairwoman at the time.<sup>112</sup> In these cases, the Board explained that the terms “agent” and “representative” in the nexus statute include selling activities by the brick-and-mortar operations of Borders and Barnes & Noble where the California store accepted returns or distributed discount coupons for the online operation. According to Chairwoman Migden, “The message behind these decisions is loud and clear: do not try to use the Internet as a tax haven for your California stores. If the end result of your Internet commerce is a physical presence in California, you are going to be treated like every other store in the state.”<sup>113</sup>

Legislation that would further clarify nexus rules is part of the effort to improve use tax collection. Appendix H lists recent legislation pertaining to the SSTP, use tax and nexus. Several attempts have been made to update the California nexus statute, which has been referred to as “ancient, but broadly worded” by Chairwoman Migden.<sup>114</sup> SB 1009, for example, effectively gave California sales tax nexus over anyone who sells tangible personal property to any state agency. The 2003 law prohibits the state from contracting with a vendor, contractor, or an affiliate of a vendor or contractor that does not possess a seller’s permit or a certificate of registration.<sup>†</sup> Similar laws have been enacted by at least six other states, including Connecticut, Illinois, Missouri, South Dakota, Virginia and

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\* The \$13 million estimate is based on its \$1.2 billion estimate for uncollected use tax, multiplied by 0.8 percent.

† Chapter 718: To the Public Contract Code, it adds Section 10295.1; To the Revenue and Taxation Code, it amends Sections 6487 and 7101 and adds Sections 6452.1, 6487.3, and 18510. Effective 1-1-2004.

Wisconsin.\* The South Dakota law was repealed in early 2004, however, reportedly because it was difficult to follow for public entities dealing with hundreds of vendors.†

California bill SB 103, as originally introduced by Senator Alpert in March 2003, sought to clarify that the processing of orders by fax, telephone or the Internet does not relieve a retailer of responsibility for collection of use tax from the purchaser if the retailer is engaged in business in California.<sup>115</sup> These provisions were not enacted into law. A remote seller is presumed to have an agent within the state if:

- The remote seller holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in California, or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof; and,
- The remote seller sells the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name, or facilities or employees of the related retailer located in this state are used to advertise or promote sales by the retailer to California purchasers.

These provisions of SB 103 also sought to clarify that “servicing” and “repairing” are part of the list of activities that give a remote retailer an “agent” or “representative” within the state. If these provisions had been enacted, the BOE estimated a revenue gain of \$21 million per year (about \$13 million state, \$6 million local, and \$2 million transit).<sup>116</sup> Many retailers have attempted to get around the state’s nexus rules by incorporating their online arms separately (a practice referred to as “entity isolation”) and putting their facilities in only a few places.

A 2004 bill authored by Senator Bowen, SB 1559, sought to start the process of conforming California’s sales and use tax laws to the SSUTA. This bill incorporated sections of the SSUTA that allow an agent for a seller or an agent for a retailer (in addition to sellers and retailers) to register with the BOE, obtain a seller’s permit, and provide any information to the BOE regarding agents operating in this state. Currently, California requires that all corporate officers, partners or owners of a business sign the application for a seller’s permit. SB 1559 would have allowed an authorized agent for the business such as an attorney or CPA to submit the application for a seller’s permit on behalf of the business. If the bill had passed, California would have had to revise its seller’s permit application to include a section for the authorized agent to sign on behalf of the business. A second provision of the bill, which was added late in the process, relates to a request by Land’s End for a seller’s permit for its operations in the City of Ontario. The bill was an attempt to prevent agreements between cities and retailers who would locate a back office in the city, with the result that all sales tax from the retailer would go to that city. The bill was placed on the inactive file at the end of the 2003-04 legislative session.

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\* Wisconsin Act 33, 2003 created sections 16.70(1b) and became effective July 26, 2003.

† South Dakota, HB 1261 (2003) and HB 1177 (2004).

## **DOT-COM RETAILERS THAT COLLECT SALES TAX AND THOSE THAT DON'T**

In February 2003, some of the nation's largest retailers started voluntarily collecting taxes on all their online sales, a switch that could have broad implications for how commerce is conducted over the Internet.<sup>117</sup> Under a deal with 38 states (California did not participate) and the District of Columbia, several big retailers, including Wal-Mart Stores Inc., Target Corp. and Toys R Us Inc., will have their online divisions collect sales tax. Under the terms of the deal, the states agreed to absolve the stores of any liability for previously uncollected online sales taxes that they might have had to pay because they have operations in so many states.

These stores said they made the change because customers want to be able to return or exchange online purchases in the companies' stores. They also hope the change will allow more aggressive joint in-store and Internet promotion and other means of blending Internet and in-store shopping. Before the deal, the retailers' online sites collected sales tax only in states where they had physical operations (nexus). For example, although Wal-Mart has stores in all 50 states, its Walmart.com subsidiary has a physical presence in only nine states.

With their decision to have their online divisions collect taxes, the retailers also are hoping to undercut arguments from online-only sellers that sales tax collection is too complicated to accomplish. How much money the tax collection will raise is not known. Neither the stores that agreed to voluntarily collect the tax nor the states would say how many retailers have joined in the agreement. The retailers have also declined to say whether they were parties to the amnesty agreement. In the 4<sup>th</sup> quarter of 2003, online sales for all stores represented only about two percent of total retail sales.<sup>118</sup>

The sales tax practices of several online retailers were described in an article in the *Wall Street Journal* in February 2003 (see Table 19).<sup>119</sup> Of these retailers, nine dot-com subsidiaries were paying California sales and use tax on their Internet sales at the time: Banana Republic, Best Buy, Gap, Old Navy, Sears, Staples, Target, Toys 'R Us, Wal-Mart. Of the nine subsidiaries, the BOE has taxable sales records for the seven companies that report their dot-com subsidiary figures separately. The BOE estimated sales and use tax revenues for the other two companies. Total 2002 revenues for the nine subsidiaries were estimated at \$33.8 million, or 1.7 percent of the combined California SUT paid by the parent corporations of these companies. The state share of \$33.8 million would be \$21.3 million. The following subsidiaries were not registered with the BOE in February 2003: Amazon, Barnes & Noble and CVS.

An example of a successful effort to collect taxes on Internet sales is the settlement of lawsuits between the state of Illinois and Wal-Mart, Target and Office Depot, announced on December 10, 2004. These retailers had established nominally separate organizations to engage in Internet sales, but the state argued that nexus was created when the firms allowed returns of articles purchased online to their parent stores in Illinois. The companies will pay \$2.4 million in back taxes and will continue to collect in the future.<sup>120</sup>

**Table 19**

<b>Dot-Com Retailers That Charge Sales Tax and Those That Don't</b> <i>Wall Street Journal, February 2003</i>		
<i>Retailer</i>	<i>Where it charges Sales Tax*</i>	<i>Why the Retailer Charges Sales Tax</i>
Walmart.com	All states with a sales tax.	Recently expanded sales tax collection so it can offer more combination services, such as in-store pickup of online orders.
Gap.com, OldNavy.com, BananaRepubl ic.com	All states with a sales tax. Some clothing and footwear is exempt in CT, MA, MN, NJ, NY, PA, RI and VT.	Conveniences like in-store returns of online merchandise mean Gap has long collected sales for purchases from all its Web stores.
Dell.com	TX, TN, FL, OH, NV, NC, PA and ID. <sup>†</sup>	Charges sales tax in any state with a Dell call center, manufacturing plant or other physical outpost.
ToysRus.com	All states with a sales tax, except AR, WY, and the District of Columbia.	Company began charging sales tax recently in all states where it has stores so that customers can return Web purchases in stores.
Target.com	All applicable states, except Hawaii and Vermont.	Recently expanded sales taxes to all its Web sites because of deeper integration of Internet operations into the company.
Staples.com	All states with sales tax except Hawaii.	The office-supply retailer says it's legally obligated to collect sales taxes because the Web site is integrated into Staples' operations.
BestBuy.com	All applicable states, doesn't deliver to Hawaii.	Web site collects in all states where Best Buy has stores.
Sears.com	All states with sales tax.	Sears store and Web operations are tightly integrated, opening Sears.com up to sales tax liability.
BarnesAndNo ble.com	NY, NJ, TN and NV.	Limited sales tax because the Web site remains separate from Barnes & Noble, Inc., but it still collects in states where it has its headquarters, customer service center, and warehouses.
CVS.com	32 states and the District of Columbia.	CVS says it collects sales taxes anywhere it has a store or other "physical presence."
Amazon.com	WA and ND	Collects sales taxes only where it has headquarters and a customer-service center.

### ***Consistent Shopping Experience***

As shoppers become more accustomed to shopping online, they expect to be able to "shop across channels," meaning shopping across the different purchasing channels: store, Internet and catalog. Shoppers would like to be able to make in-store returns of online purchases, make in-store pickups of online purchases, and have stores honor discounts and other offers available online. The movement of companies towards

\* Alaska, Delaware, Montana, New Hampshire and Oregon don't have a state sales tax. Some states charge sales tax on shipping, too.

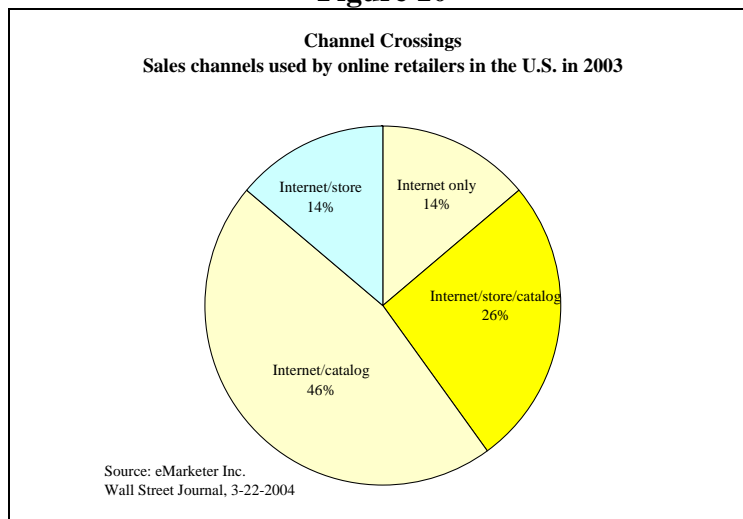
<sup>†</sup> Dell.com currently charges sales tax in California.

integrating the shopping experience across all channels is important for sales tax collection because in-store returns of online purchases will give a company nexus for purposes of California sales tax collection.\* The Board of Equalization has taken the position that accepting returned products on behalf of an out-of-state retailer does meet the definition of a retailer engaged in business in this state.

How easy is it for retailers to offer a “consistent shopping experience?” According to a March 2004 *Wall Street Journal* article, from the merchant’s point of view, integrating the shopping experience requires substantial investments in expensive technological upgrades.<sup>121</sup> The problem is out-of-date technology, and disconnected customer and inventory databases. Keeping inventory available to satisfy online orders can be difficult.

More than three-quarters of online retailers with real-world stores allow in-store returns of items purchased online, including Gap and J. Crew, according to Forrester Research Inc. and Shop.org, the online unit of the National Retail Federation in Washington. So far, in-store pickups of items purchased online are available at 13 percent of retailers.<sup>122</sup> The experiences of individual stores are instructive. In June 2003, Recreational Equipment Inc. (REI) added in-store pickups of online purchases and has found that Internet customers spend an average of \$30 while they are there. Similarly, Sears, Roebuck & Co. found that about 30 percent of those who buy something online but pick it up in person spend more when they arrive in the store. Macy’s, which integrated its online gift registry with other parts of the store, has found it to be very profitable. However, the store does not plan to integrate all of the store’s merchandise into one database because there would simply be too many items for the website to buy, store and catalog.<sup>123</sup> The breakdown of “channel crossings” was reported by the *Wall Street Journal*:

**Figure 10**



\* *Annotations, Business Taxes Law Guides*: 220.0002 Accepting Returned Products on Behalf of Out-of-State Retailer. 6/22/99. (2000-1).

## ***The Growth of Multi-Channel Retailing***

According to a July 2004 report commissioned by the National Governors Association and the National Conference of State Legislators, Forrester Research found that established “brick and mortar” stores like Borders and Wal-Mart are increasingly selling their goods online. “With the exception of online sellers Amazon.com and eBay, the majority of online sales are by the same retailers that dominate offline sales.” These ‘multi-channel retailers’ constituted 75 percent of total on-line sales in 2003, up from 67 percent in 2001.<sup>124</sup>

Forrester also found more rapid growth of Internet sales among multi-channel retailers than among pure e-tailers: Internet sales at multi-channel stores such as Target and Sears grew almost 60 percent in 2002 and 32 percent in 2003, whereas Web-based retailers grew only 13 percent in 2003. Due partly to the expansion of broadband technologies into American homes, Forrester expects online retailing annual growth of nearly 20 percent in the next five years.<sup>125</sup>

## **CALIFORNIA PUBLIC OPINION POLL: TAXATION OF INTERNET SALES**

Californians’ attitudes towards tax and spending proposals are surveyed regularly by the Public Policy Institute of California (see Table 20). These surveys covered general support for spending cuts and tax increases, and as well as support for specific proposals such as collecting sales/use taxes on Internet sales.

In June 2003, 57 percent of Californians said taxing all goods sold over the Internet would be a good idea. Majorities of Democrats (60%), Independents (54%), and Republicans (53%) favored this proposal. Two-thirds (66%) of those who had never gone online to purchase goods or services thought that this would be a good idea, compared to only 48 percent of those who had shopped on the Internet. Californians aged 55 and older (63%) were more likely than those aged 35 and under (53%) to think that all Internet sales should be taxed.<sup>126</sup>

**Table 20**

California Public Opinion Poll: How about taxing all goods sold over the Internet?	All Adults	Party Registration			Likely Voters
		Dem.	Rep.	Ind.	
Favor	57%	60%	53%	54%	55%
Oppose	38	34	42	43	39
Don't Know	5	6	5	3	6
Source: Public Policy Institute of California, June 2003.					

## SURVEY OF PRIVATE BUSINESS ATTITUDES TOWARDS THE SSUTA

PricewaterhouseCoopers' "Trendsetter Barometer" interviewed CEOs of 387 privately-held product and service companies identified in the media as the fastest-growing U.S. businesses over the last five years.<sup>127</sup> The surveyed companies ranged in size from approximately \$5 million to \$150 million in revenue/sales. The CEOs were asked about the "Streamlined Sales and Use Tax Act" now before Congress and the state-sponsored SSUTA, which has already been adopted entirely or in part by 20 states. Under the SSUTA, 88 percent of the 387 private companies surveyed would be subject to a multi-state registration requirement because they conducted business across state lines. If the federal legislation were passed, these companies would be required to collect taxes in all conforming states where they have sales.

Despite the high percentage of respondents engaged in interstate commerce, few – only 28 percent of surveyed CEOs – had advance familiarity with either of the streamlining efforts. Only one-in-five CEOs familiar with the proposed federal legislation or state agreements claimed to have compliance plans in place or in development. Therefore, out of all surveyed companies, only about five percent had compliance plans. In general, multi-state marketers were wary of the effect of the streamlining efforts on their businesses. Among the 67 percent of surveyed companies marketing in five or more states, only one-third reported having current difficulties and high administrative costs for fulfilling their sales and use tax obligations (see Table 21). If the proposed federal legislation were passed, 44 percent expected it would have a damaging effect on their profit growth; only five percent said it would be beneficial.

**Table 21**

CEO Business Survey on the SSUTA: The New Legislation Would Be...	Companies with Multi-state Sales	
	5+ States (67%)	Less than 5 States (21%)
Beneficial	5%	4%
Damaging	44%	39%
No Impact	15%	21%
Doesn't Apply/ Tax Exempt	9%	3%
Not Certain	20%	26%
Not Reported	7%	7%

Source: PricewaterhouseCoopers' *Trendsetter Barometer Survey*, April 7, 2004.

## ONLINE RETAILERS IN EUROPE PAY SALES TAX (VALUE ADDED TAX)

In Europe, anything bought on the Internet is subject to the value added tax (VAT), whether the seller has physical operations there or not. The VAT varies from country to country – as high as 25 percent in Sweden to as low as 13 percent on the Portuguese island of Madeira – and is often factored into prices so consumers don't know they are paying it. On July 1, 2003, a new European Union (EU) law went into effect requiring non-EU companies to levy the VAT on fees paid for Internet service, as well as for products downloaded by customers in Europe, such as software, music and videos.

According to the *Wall Street Journal*, the new tax rule stems from European companies' call to level the e-commerce playing field.<sup>128</sup> By not having to pay the VAT, European companies argued that their U.S. competitors have had an unfair advantage. But U.S. authorities say the new rule discriminates against U.S. companies without European operations. European companies and U.S. companies with European subsidiaries can use a single country's rate based on where their headquarters are. They don't have to determine where their customers live, so they avoid costly red tape. In contrast, U.S. companies without a European unit have to follow 15 different VAT regimes; in 2004, that will increase to 25 as the EU adds Southern and Eastern European members.

Some large U.S. technology firms, such as Amazon.com, eBay and AOL, already had a European presence and have started charging the VAT rate according to where their affiliates are based. Amazon.com had already been charging VAT for retail sales, including books and compact discs, in Europe based on where the customer lives. Starting July 1, 2003, the online retailer, through its Luxembourg subsidiary, began charging VAT on the fees sellers pay to put up products for sale on its Web site. Large firms are reportedly able to absorb the VAT themselves and avoid charging the tax.

For small companies, many are likely to ignore the tax. They often don't have the resources to set up a European subsidiary to be able to charge one VAT rate, nor the know-how to overhaul their Web sites to account for the different rates, and then start collecting, reporting and distributing the VAT. The EU has yet to work out the mechanics involved in monitoring online companies' VAT compliance and small companies might figure it is worth the risk to flout the rules. For small firms, it will not be easy to absorb the costs of the new law, but if costs are passed on to the customer in the form of higher prices, these firms are worried they will lose their competitive edge.

## EVALUATIONS OF THE SSUTA

A vast literature exists evaluating the taxation of remote sales. Several authors have specifically evaluated the Streamlined Sales and Use Tax Agreement. Professors Walter Hellerstein and John Swain wrote an entire book devoted to streamlining, *The Streamlined Sales and Use Tax*, 2004. Another literature compares different sales tax reform proposals such as a national sales tax, the Streamlined Sales Tax, etc. In this section of the report, several examples of SSUTA evaluations are summarized.

### PROFESSOR JOHN MIKESELL

Professor John L. Mikesell of Indiana University, an acknowledged sales tax expert and frequent critic of many state tax practices, published an evaluation of the Streamlined Sales Tax Project in *State Tax Notes* on April 28, 2003. His conclusion: While the Agreement misses some opportunities to improve the sales tax, it represents “a considerable achievement” that, when implemented, will make compliance easier for sellers and, on balance, move the states toward an improved sales tax structure.

Concerning the Agreement’s missed opportunities, Mikesell notes that having standard definitions may induce states to adopt new sales tax laws. Businesses fear that some definitions, particularly in regard to food, may encourage base broadening. In addition, the definitions in the Agreement suffer from some important omissions:

- Failure to exclude business purchases from sales tax.
- Failure to include household purchases of services in the tax base.
- Failure to include services delivered over the Internet (e.g. music and video games) in the tax base. While tangible personal property can be advertised, ordered and paid for through the Internet, services may also be delivered through the Internet, thereby making it almost impossible for purchases to be tracked via means normally available to individual tax departments.
- Failure to include a minimum sales threshold below, which a firm need not register as a tax collector in a state. This means that many firms will potentially face compliance costs much in excess of tax remitted to some states.

In Table 22, various sections of the Agreement are evaluated by Professor Mikesell based on three general standards for sales tax evaluation outlined by John Due:<sup>129</sup>

1. Equity. Distribution of burden among various individuals in a manner regarded as equitable in the contemporary society.\*
2. Economic Neutrality. The avoidance of adverse effects on the functioning of the economy, such as mal-allocation of resources or loss of efficiency in production.
3. Administration. Effective administration and compliance at reasonable cost.

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\* Equity is usually considered to require (1) the avoidance of obvious discrimination among individuals without acceptable justification, and (2) an overall distribution of burden by income class, a stipulation that conforms with the socially accepted standards of desirable income distribution.

**Table 22**

<p align="center"><b>Professor Mikesell 2003 Evaluation of the SSUTA</b> <i>State Tax Notes, April 28, 2003</i></p>
<p><b>Level of Administration (301)</b> – The state sales tax authorities must administer any local sales tax levied within its boundaries; any local taxes must use the same base as does the state (after 2005); and only one local rate must apply in the state. The first two provisions almost unambiguously reduce collection cost and may increase the overall quality of administration with no increase in cost. The third provision, in addition to making compliance less costly, also promises to reduce distortion of sales driven by differences in sales tax rates among jurisdictions.</p> <p><u>Mikesell Assessment:</u> These provisions are clearly consistent with the evaluation standard -- even though they are likely to raise local government objections in states that have adopted local sales tax rates and in states in which localities administer sales taxes on their own.</p>
<p><b>Reduction of Multiple Tax Rates (308)</b> – States are permitted to levy two general state tax rates, one standard rate and the other a reduced rate for food and drugs. Because some transactions are certain to be exempt (or taxed at zero rate) because of the nature of the item, the nature of the purchaser, or the nature of the intended use, transactions may be reported potentially in three different rate categories. This treatment is better than the multiple rates levied in some Southeastern states, but certainly less advantageous than a two-rate system (standard and zero) for reducing compliance and administrative costs and for preventing inefficient distortions.</p> <p><u>Mikesell Assessment:</u> This provision moves toward meeting the evaluation standard, so long as it does not induce some states that do not have reduced food and drug state tax rates to enact them. Will it be possible, within the terms of the agreement, to adopt a single rate for the sales tax, fully exempt certain sales, then tax those sales in a separate excise tax, in the manner that some states (such as Kentucky, Maryland and Texas) handle motor vehicle sales now, and remain in legal compliance?</p>
<p><b>Uniform Sourcing Rule (309-315)</b> - The agreement establishes rules for determining the taxing jurisdiction in a multi-jurisdictional transaction that favor the destination of the product being sold.</p> <p><u>Mikesell Assessment:</u> This rule facilitates transparent collection from product consumers.</p>
<p><b>Sales Tax Holidays (322)</b> – The agreement establishes uniform rules for sales tax holidays. The implicit acceptance of sales tax holidays that their inclusion in the SSUTA implies violates both the economic neutrality and administrative/compliance cost standards.</p> <p><u>Mikesell Assessment:</u> Sales tax holidays are “dumber than a bag of hammers.”<sup>130</sup> If there ever was a provision designed to make compliance more difficult for remote vendors, as well as distorting consumer choices, this is it. Any provisions designed to perpetuate such holidays are a loss for sound tax policy.</p>
<p><b>Caps and Thresholds (323)</b> – The agreement eliminates caps that limit the amount of tax that may be collected on a purchase and thresholds that exclude amounts above or below the threshold from tax or apply different rates on both sides of a threshold.</p> <p><u>Mikesell Assessment:</u> This prohibition moves sales taxes toward meeting the neutrality standard and lowering the administrative/compliance cost standard.</p>
<p><b>Rounding Rule (324)</b> – The agreement replaces brackets with the major fraction rule when sales tax calculation creates fraction cents of tax due. The provision makes calculation of tax easier and will reduce compliance cost. States using brackets that round before the major fraction will lose some revenue and one audit key.*</p> <p><u>Mikesell Assessment:</u> The Agreement makes compliance and administration easier.</p>

\* An audit key is a factor for selecting audits.

**Table 22 (continued)**

<p align="center"><b>Professor Mikesell 2003 Evaluation of the SSUTA</b> <i>State Tax Notes, April 28, 2003</i></p>
<p><b>Uniform Definitions of Goods and Services (327)</b> – The Agreement does not require that certain exemptions and exclusions must be used, but does require the use of standard definitions if they are. Important definitions include those for “food” and “food-related purchases,” “drugs,” “clothing,” and “tangible personal property.” Accommodation of the food and prescription drug exemptions helps make the tax more equitable, although the food exemption does increase administrative/compliance costs.* However, accommodation of clothing and nonprescription drug exemptions complicates administration/compliance with doubtful equity gains.</p> <p><u>Mikesell Assessment:</u> The common definitions may reduce compliance and administration costs. However, if the definitions induce states to exempt commodities that are currently taxed, the tax base will diverge more from the uniform tax on consumption standard, there may be non-neutral effects on consumption expenditures, and collection costs will increase.</p>
<p><b>Registration and Amnesty (402)</b> – The Agreement requires each state to participate in an online sales-and-use tax registration system in which registration in one state suffices for all Agreement states. This provision should reduce compliance costs. However, firms may be registered in states in which they do not conduct business. That promises some increase in administrative cost, as states sort out those firms from its return distribution and delinquency control systems. In addition, sellers that participate will receive an amnesty for uncollected/unpaid sales and use tax that is not already the subject of audit.</p> <p><u>Mikesell Assessment:</u> Such a registration system will reduce compliance costs, but may increase administrative costs if there is no screen to prevent over-registration, that is, automatic registration with states in which the firm does no (or even minimal) business.</p>
<p><b>Vendor Compensation and Technology Models for Remittance (501)</b> – Registering firms may opt for three remittance approaches: a certified service provider that acts as the firm’s agent in all sales and use tax functions; a certified automated system acquired by the vendor to handle tax calculation, remittance and recordkeeping; or self-compliance with a performance standard agreed with each member state. The agreement anticipates payment for collection work done under each model, but does not specify the amounts to be paid or their calculation basis.</p> <p><u>Mikesell Assessment:</u> The system may or may not reduce the cost of compliance and administration, but it does promise to make the cost more transparent.</p>

## CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY

California’s participation in the Streamlined Sales Tax Project is one of the tax reform options considered by the California Commission on Tax Policy in the New Economy.<sup>131</sup> In its *Final Report*, issued December 2003, arguments for and against joining the SSTP are evaluated, using a framework of three guiding principles: fairness, simplicity and efficiency.<sup>†</sup> The Commission’s analysis follows:

\* The simplification of some definitions, notably those involving the food exemption, are almost certainly of greater value in terms of reduced compliance cost of local merchants than for remote vendors.

† The principles used by the Commission were based on: “Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals,” New York: Tax Division of the American Institute of Certified Public Accountants, 2001.

**Table 23**

<b>California Commission on Tax Policy in the New Economy: Participation in the Streamlined Sales Tax Project</b>		
<i><b>Guiding Principle</b></i>	<i><b>Pro</b></i>	<i><b>Con</b></i>
Fairness	Remote sellers currently are not required to collect state sales taxes, while those retailers with a physical nexus in the state are required to collect such taxes. By streamlining the sales tax, the SSTP agreement will help move towards a more level playing field between remote sellers and firms with physical nexus.	<p>California is one of the largest economies in the world; yet, under the SSTP, California would have one vote and would be buying into a proposal that is 85 percent complete. California would be joining the SSTP too late to influence the process.</p> <p>Participation in the SSTP in and of itself will not level the playing field by allowing for the taxation of all remote sales. Implementation will still require federal approval. Real fairness will prevail when this matter is addressed by the Congress and becomes a national policy.</p>
Simplicity	Currently there are approximately 7,500 different sales tax collection districts in the United States, all using a wide variety of rates and definitions. The Project's goals are to provide uniform definitions, rate simplification, ease of administration, simplified exemptions, and uniform audit procedures.	<p>Conforming California's laws to the SSTP will require an overhaul of California's sales and use tax system.</p> <p>Under the SSTP, legislatures choose what is taxable or exempt in their state. However, participating states must agree to use the SSTP's common definitions for key items in the tax base. There are definitional differences between California law and the existing SSTP definitions. To conform to the common definitions, some products currently exempted from taxation in California might have to be taxed, or alternatively, some products currently taxed would be exempted. The entire sales-tax system must be brought into compliance with the SSTP, not just that for remote sellers.</p> <p>SSTP would still allow different tax rates. Exemptions would still allow states to have 50 different codes.</p>
Efficiency	<p>Compliance with the SSTP's final product will allow for a more predictable sales tax base since it will stop the leakage resulting from the growth of remote sales.</p> <p>Administrative burdens on the state will be decreased.</p> <p>The SSTP has resulted in the development of software and technology models to aid in the administration of sales and use tax collection.</p> <p>These changes would decrease consumption distortions and allow for the possibility of decreasing the sales tax rate, which would reduce the excess burden of the tax.</p>	<p>Conformity with the SSTP will not necessarily result in additional taxes being collected and will not stop the leakage resulting from remote sales growth. Only if Congress enacts a federal statute authorizing states to compel the collection of state sales and use tax by out-of-state retailers will states be able to impose and obligate the collection of taxes.</p> <p>Businesses would be burdened with identifying the location of the purchaser.</p>

### ***Should California Participate in the Streamlined Sales Tax Effort?***

During 2002 and 2003, the California Commission on Tax Policy in the New Economy held numerous hearings on ways to reform the California tax system. The Commission was created following Governor Davis' veto of SB 1949 in 2000, which would have made California a voting participant in the SSTP had it been approved. Explaining the veto, Governor Davis stated that California's participation in the SSTP was unnecessary because of its participation in other multi-state groups. After the veto, Senator Vasconcelles authored SB 1933, which created the Commission and assigned the study of California's SSTP participation as one of the Commission's mandates.

Detailed hearing testimony is included in the *Proceedings* of the Commission, which are available online at: <http://www.library.ca.gov/CaTax/index.cfm>. Sales and use taxes and the SSTP were discussed at seven Commission hearings. A list of relevant speakers and their presentation topics are included in Appendix I.

### ***California Should Participate as a Voting Member of the SSUTA***

At the first meeting of the Commission on Tax Policy in the New Economy in January 2002, Professor Charles McLure stated that California should participate fully as a voting member in the SSTP:

"California's failure to participate in the SSTP as a voting member is inexcusable. Some may object to the suggestion that remote vendors, including those engaged in electronic commerce, should collect the same tax as local merchants. If remote vendors do not collect tax, the reasoning goes, they will have a competitive advantage over local vendors and that will be good for Silicon Valley and for California. But let's examine the argument more closely.... It is only the tax on taxable sales remote vendors make to consumers – all such sales to consumers in the conceptually ideal tax – that are really at issue. Here the question is one of basic fairness and economic good sense. It is not fair or sensible to place local merchants at a competitive disadvantage, by allowing remote vendors to exploit the California market without collecting the tax that local merchants must collect. And a policy that artificially encourages shipment of individual packages to homes, instead of boxes to stores, does not make economic sense. Nor for that matter, does a policy that artificially encourages online delivery of digital content. Sales taxation should be neutral."<sup>132</sup>

Many speakers before the Commission stated that California should actively participate as a voting member in the streamlined sales tax effort. The reasons given were:

1. The current sales and use tax system is increasingly complex and a burden on multi-state business.
2. We need to create a level playing field between those with nexus and those without. It's an issue of tax fairness to brick-and-mortar businesses.
3. The state is losing revenue due to remote sales. The structure of the sales tax needs to reflect the structure of the new economy.

4. California should participate so that the Agreement will be on terms favorable to the state. Since the SSTP is the multi-state effort that almost all states with sales taxes are working on, it does not make sense for California not to be at the table.
5. Other solutions to the problem of the non-collection of the use tax on remote sales have not worked well. The use tax is expensive administratively to collect, the BOE staff is small, and the BOE does not have jurisdiction over out-of-state sellers. It is difficult for the BOE to find out about individual purchases without the cooperation of out-of-state vendors.

### ***Should California Conform its Laws to the SSUTA?***

While most speakers advocated participating as a voting member in the SSUTA, several made it clear that amending California's sales tax laws to conform to the Agreement would have far-reaching consequences and is a step that needs more research. On March 12, 2003, the California Board of Equalization (BOE) staff made a presentation to the Commission outlining challenges for California with respect to the SSUTA:

- Compliance with the SSUTA would require a dramatic overhaul of California's sales and use tax system.
- California would not be able to deviate from the Agreement's definitions, which would impact the sales taxation of many goods.
- The Agreement's destination-based sourcing rules would result in the reallocation of California's local sales tax revenues.
- By 12-31-05, no partial exemptions would be allowed.\*
- The Agreement allows exemptions by use of entity, but which entities would have to be determined.
- California would have to put in place provisions to compensate vendors for sales and use tax collection, which the state currently does not do.
- Numerous new systems and databases, such as online registration, would be required.
- The Agreement's amnesty provisions are different from current California law.
- The SSUTA Governing Board would give only one vote to California, which would shift control of California's sales tax out of the hands of the legislature and the BOE to the SSUTA Governing Board.
- Even if California conforms its laws, the system is voluntary, and California won't get much additional revenue without an act of Congress.

On October 23, 2003, Steven Kamp presented the testimony of Board of Equalization Chairwoman Carole Migden. The testimony notes that, "California is ready for any federal legislation that results from the Streamlined Sales Tax Project Agreement, but should only enact SSTP legislation after insuring that the SSTP legislation passed by Congress does not limit California business activity taxes, or the California sales and use

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\* See <http://www.boe.ca.gov/sutax/sutexempt.htm>.

tax revenue base, other than the requirement that each state use a single rate for taxing remote sales. *California has been in compliance with this requirement for more than a decade.* In 1987 – when this issue was called “catalog sales” – California enacted Revenue & Taxation Code Section 6203©(4)(B),<sup>133</sup> which applies the basic California sales tax rate (i.e., no local add-on taxes) to remote sales ‘upon the enactment of any congressional act that authorizes states to compel the collection of state sales and use taxes by out-of-state retailers.’”<sup>134</sup>

### ***California Should Not Actively Participate in the SSUTA***

Two speakers before the Commission, Mr. Dean Andal (5/16/02) and Mr. Lee Goodman, Esq. (7/29/02),\* felt that the challenges outlined above would be so disadvantageous to California that the state should not actively participate in the SSUTA. On May 15, 2003, Commissioner Glen Rossman submitted a memo outlining his concerns with the SSUTA, which is included in Appendix J.

Mr. Andal made several remarks concerning the limited scope of Internet sales that are subject to California sales tax. He said that 50 percent of all California Internet sales involve the purchase of airline tickets or common stocks, which are not subject to California sales tax; 40 percent are B-to-B transactions, which are also precluded from California sales tax. He surmised that the remaining 10 percent of California Internet purchases were primarily books and clothing and were of such small dollar value compared to other transactions (two percent of dollar sales) that it would not be worth the effort to incorporate those sales into the California tax codes. Concerning the level-playing-field arguments for joining the SSUTA, Mr. Andal countered that the shipping costs of many items exceed the sales tax. He concluded that Internet sales are more subject to an un-level playing field than the sales of traditional retailers. Internet sales are driven by customer convenience and not by an effort to circumvent the California sales tax.<sup>135</sup>

Mr. Lee Goodman stated that the SSTP has a long way to go to meet the promise of *true reform, true simplification, and burdenless sales tax collection* in the new economy. Some of the issues he raised at the Commission hearing are:

- SSTP perpetuates significant complexities and burdens for businesses and consumers engaged in electronic and catalog interstate commerce,
- SSTP does not provide real or perpetual uniformity across the states or over time,
- SSTP’s promise of a technology fix has not been demonstrated to work efficiently for all businesses in America,
- SSTP does not know how much interstate sales tax collection will cost businesses, even with a technology fix,

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\* Mr. Dean Andal is Director of State and Local Tax Practice at KPMG in Sacramento. He was formerly a member of the Board of Equalization. Mr. Lee Goodman is an attorney with Wiley, Rein & Fielding in Washington D.C. Commissioner Glenn Rossman is Vice President of the Tax Department, Cisco Systems.

- SSTP has rejected the ACEC Report's\* call for revenue neutrality and proposes obvious and hidden expansions in the amount of taxes American taxpayers pay,
- SSTP has several direct and harmful tax consequences for certain segments of society, such as senior citizens, farmers and families with children,
- SSTP does not adequately protect consumer privacy, and in several ways exposes consumers to new threats of privacy breaches, and
- SSTP proposes to open online content, data, entertainment and information to sales taxes and threatens to expand sales taxes to services in the process.

Nonetheless, Mr. Goodman acknowledged that “the significance of the SSTP and what it represents for tax policy in the United States cannot be understated. It represents an attempt at perhaps one of the most sweeping changes in national tax policy in decades. And lurking in its esoteric details are several momentous policy and practical implications for businesses, taxpayers and consumers, as well as the entire economy of the United States for decades to come. Therefore, it deserves close and constructive scrutiny.”<sup>136</sup>

## GOVERNOR OWENS OF COLORADO AND THE SSUTA

In 2003, Governor Owens of Colorado issued a white paper, “*Nine Problems With Taxing the Internet*,” critiquing the Streamlined Sales and Use Tax Agreement (SSUTA).<sup>†</sup> According to the National Conference of State Legislatures (NCSL), the white paper presents a number of misconceptions about how the Agreement would affect transactions over the Internet. In response, the NCSL has posted a document, “Governor Owens’ Nine Misconceptions about the Streamlined Sales and Use Tax Agreement.”<sup>137</sup> This section summarizes the debate.

### 1. Is the SSTP<sup>‡</sup> revenue neutral?

*Owens: No. SSTP will increase the tax burden on most American consumers...States that currently exempt certain goods from taxation could be forced to extend sales taxes to currently untaxed products.... Those states that do not currently reimburse in-state merchants for their costs of collection will be mandated to pay a uniform reimbursement rate for all merchants, whether in state or out of state.*

*NCSL: Yes. If a state so decides. Each state legislature has the authority or the sovereignty to make their participation with the Streamlined Sales Tax Agreement revenue neutral.*

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\* In March 2000, the U.S. Advisory Commission on Electronic Commerce (ACEC) sent a majority report to Congress. This commission was created by the Internet Tax Freedom Act of 1998. The panel was not able to make recommendations on many of the major issues because the required 2/3 majority vote was not obtained at: <http://www.ecommercecommission.org/>.

<sup>†</sup> [http://www.cnaonline.org/Internet\\_Tax\\_Final.pdf](http://www.cnaonline.org/Internet_Tax_Final.pdf). This document was issued under the auspices of the Center for the New American Century, founded by Governor Owens in January 2003.

<sup>‡</sup> The NCSL rebuttal points out that Governor Owens’ white paper mistakenly refers to the Streamlined Sales Tax Project (SSTP). According to NCSL, the correct term is the SSUTA (Agreement).

**2. Will the Agreement simplify tax compliance for America's merchants as its proponents suggest?**

*Owens: No. SSTP foists national sales tax collection obligations upon each merchant in America... Merchants will even be responsible for determining each customer's nine-digit zip code... If an auditor concludes the merchant under-collected a state or local government's due share, the merchant will have two options – pay the difference or pay a lawyer to litigate.*

NCSL: Yes, even if the states did nothing more than adopt the proposed administrative changes contained in the Agreement, all vendors would enjoy reduced compliance complexity. Under the Agreement, all merchants would be held harmless for any miscalculations.

**3. Does the Agreement pose threats to consumer privacy?**

*Owens: "Yes...the software would calculate the tax due and remit the tax to the destination state and locality...the collection agent would gain access to information about individual consumers and what they purchase...the disparate and often confusing laws of 50 different states...supercede any SSTP (privacy) "precept"... Will her personal information and purchase choices be protected under Colorado law, where she lives, or under the law of the state where her vendor operates?"*

NCSL: No, the Agreement provides that a certified service provider "shall perform its tax calculation, remittance and reporting functions without retaining the personally identifiable information of consumers."

**4. Will the Agreement require your state and its local jurisdictions to forfeit sovereignty over tax policy in your state?**

*Owens: "Yes...tax policy would be ceded to and dictated by a board of unelected and unaccountable out-of-state tax bureaucrats...SSTP requires each state to submit its sales tax system to oversight of a "governing board"...will be vested with administrative, legislative and judicial powers over each participating state's tax policy...it can amend the SSTP with 60 days notice...altering each state's tax laws."*

NCSL: No, compliance to the Agreement is always optional for a state. The decision to comply with the provisions of the Agreement can only be made by each state legislature and governor – and they can withdraw at any time.

**5. Is the Agreement consistent with the Constitutional doctrine of federalism?**

*Owens: No...SSTP would allow participating states to reach across state lines and foist their tax and regulatory burdens upon out-of-state businesses and citizens conducting business on the Internet...Businesses...would be subject to the SSTP's scheme even if their home state democratically chooses not to join the uniform tax regime.*

NCSL: Yes. The Agreement is voluntary for states and for merchants. This is not a mandatory compact or violation of the Commerce Clause of the Constitution.

**6. Will the Agreement reduce tax policy competition between states?**

*Owens: Yes. The SSTP rewards the least competitive states by allowing them to “dumb down” the tax code...the SSTP effectively undermines the notion of states as “laboratories of democracy”...it allows 10 participating states to piggy-back on the economics investments of 40 other states. It attempts to coerce all states into following minority policy – a virtual “tax cartel.”*

NCSL: No, the state legislature in each state that complies will still decide what is taxed, who is exempt, and at what rate it wants to tax transactions.

**7. Will the Agreement impede the success of the technology revolution?**

*Owens: “Yes. Attaching tax burdens to each online transaction will dampen enthusiasm for Internet usage and stifle technological innovation. Some people will...log off rather than fill out the requisite tax form...even more troubling is that the proponents of a new national sales tax on the Internet are busily working to craft a policy for imposing state and local taxes on...digital goods...software delivered electronically and uploaded on one’s computer...the growth of the digital economy, and the family-sustaining jobs spawned by it, could be placed in jeopardy.”*

NCSL: No, the Agreement provides for technology that will not add any additional forms for the online buyer to complete. The information the buyer provides for the delivery or payment of the product is sufficient to determine the correct sales tax.

**8. Will the Agreement hurt certain citizens more than others?**

*Owens: “Yes. New online transaction taxes will disproportionately punish rural, disabled or even elderly buyers...SSTP will therefore have the effect of widening the so-called ‘digital divide.’”*

NCSL: No, all buyers in a state that complies with the Agreement will pay the same sales tax on a transaction regardless if it occurs in a brick-and-mortar store or online.

**9. Will the Agreement really promote equity between brick-and-mortar and online retailers?**

*Owens: No...what about compliance costs...compliance costs would put online merchants at a competitive disadvantage...online merchants are not eligible for the many benefits governments sometimes offer traditional retailers.*

NCSL: Yes, all transactions regardless of the way they are purchased will be treated the same under the Agreement and all retailers will receive reasonable and adequate compensation to cover the costs of collection.

## PROFESSOR CHARLES McLURE

Professor Charles McLure, a senior fellow with the Hoover Institution at Stanford University, has written extensively about sales tax policy. He presented his ideas for improving California sales and use taxes to the Commission on Tax Policy in the New Economy on January 29, 2002, as well as to the Roundtable Discussion of State Tax Policy sponsored by the Senate Office of Research on December 3, 2002.<sup>138</sup> His three fundamental tenets of sales tax policy are:

- If a household buys it, it is taxable.
- If a business buys it, it is exempt.
- Keep it simple.

In a 2003 article, Professor McLure suggested that “to reduce the nuttiness of the sales tax, California needs to eliminate exemptions for virtually all goods (including food) and services, exempt virtually all sales to businesses, and eliminate other needless complexity.”<sup>139</sup> California, acting alone, cannot do much about two of the nuttiest aspects of the sales tax system: the complexity created by the lack of uniformity from state to state and the resulting judicially-imposed inability to require out-of-state vendors that lack a physical presence in the state to collect use tax on sales made to purchasers in the state. Professor McLure lamented the failure of California to participate in the streamlined sales tax effort, both from the national point of view and from state’s self-interest. California’s failure to participate can only impede efforts to “drain the sales tax swamp.” He noted that the Agreement’s clear objective is not so much simplification for its own sake, but achievement of enough uniformity that Congress will overturn the *Quill* decision.\* According to McLure, “California should assume its proper leadership role in the sales tax arena by enacting the Agreement at the earliest opportunity.”<sup>140</sup>

In 2004, Professor Walter Hellerstein, of the University of Georgia Law School, and Professor McLure analyzed the SSUTA with respect to the merits of Congressional intervention in state taxation.<sup>141</sup> Legislation has been introduced in Congress authorizing the states, under specified conditions, to require collection of sales and use taxes regarding sales by remote sellers, despite their lack of physical presence in the state (otherwise constitutionally required under the *Quill* decision), if the states conform to the provisions of the SSUTA.† The legislation “consents” to the Agreement, thereby authorizing the states, consistent with other provisions of the legislation, to require collection of taxes on remote sales despite *Quill*. If the states satisfy the Agreement’s requirements, Congress would authorize collection by remote sellers, with several additional conditions and limitations, including an exception for small sellers (those with less than \$5 million of nationwide remote sales) and a federal court review of controversies arising under the Agreement.

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\* U.S. Supreme Court, *Quill vs. North Dakota* (504 U.S. 298, 1992).

† The legislation referred to here is the “Streamlined Sales and Use Tax Act,” S 1736, 108<sup>th</sup> Congress, 1<sup>st</sup> Session (2003).

Based on the normative criteria outlined in their analysis, McLure and Hellerstein state, “We believe that the SSUTA is fundamentally a move in the right direction – the prescription of simplification and greater uniformity in conjunction with the removal of nexus rules that create undesirable economic consequences.” They find that the Streamlined project represents the best hope for resolving major issues in the sales tax system and recommend that Congress grant states in the Agreement the authority to require remote sellers to collect. However, this support is not without some reservations. They argue that the states should have done more to simplify sales taxes, particularly in dealing with taxation of business inputs, but they find the prospect of remote sellers not being required to collect even more objectionable. “It is essential that Congress examine carefully the extent to which the efforts of the states to implement the streamlined agreement have adequately simplified and harmonized the states’ sales and use tax.” As the authors point out, the “devil is in the details and there is considerable controversy as to whether the efforts of the states to implement the Agreement satisfy the promise of meaningful simplification.”<sup>142</sup>

Over the years, Professor McLure has urged strict adherence to destination-based taxation, on which the SSUTA relies. In January 2000, he mobilized 116 academics to indicate support of an “Appeal for Fair and Equal Taxation of Electronic Commerce,” which includes the following general principles:<sup>143</sup>

1. Electronic commerce should not permanently be treated differently from other commerce. There is no principled reason for a permanent exemption for electronic commerce. Electronic commerce should be taxed neither more nor less heavily than other commerce.
2. Remote sales, including electronic commerce, should, to the extent possible, be taxed by the state of destination of sales, regardless of whether the vendor has physical presence in the state. In limited cases, where it is impossible to determine the destination of sales of digital content to households, it may be necessary to substitute a surrogate system. In no case should taxation of remote commerce or electronic commerce be limited to origin-based taxation, which would induce a “race to the bottom” and, in effect, no taxation at all.
3. There must be enough simplification of sales and use taxes to make destination-based taxation of sales feasible. Such simplification might include, for example, unification of the tax bases across states, unification of tax rates within states, and/or sourcing of sales only to the state level, as well as simplification of administrative procedures.
4. A means must be found to eliminate burdens of compliance on sellers making only small amounts of sales in a state. These might include software-based systems made available at state expense, more realistic vendor discounts, and/or *de minimus* rules.

## DIRECT MARKETING ASSOCIATION

George S. Isaacson, tax counsel to the Direct Marketing Association, testified before the U.S. House of Representatives Committee on the Judiciary Subcommittee on Administrative Law, on October 1, 2003.<sup>144</sup> His major points were:

- I. State tax administrators are asking Congress for an unprecedented expansion of state taxing authority.
- II. The SSTP failed to meet its own standards for a streamlined sales and use tax system.
  - A. The SSTP rejected real rate simplification by summarily dismissing the principle of ‘one rate per state,’ the most fundamental reform necessary for a simplified sales/use tax system.
  - B. The SSTA blindly relies on non-existent tax compliance software, but the SSTP’s own tests show such software cannot be developed.
  - C. The SSTP abandoned its commitment to protect consumer privacy.
  - D. The SSTA fails to reduce administrative burdens on retailers.
  - E. The SSTP failed to conduct a promised cost-of-collection study, necessary to evaluate the true costs of the expanded tax collection system it seeks to impose on interstate marketers.
  - F. The SSTA fails to ensure compliance with terms of the Agreement by member states.
- III. The diluted Agreement adopted by the SSTP is not meaningful simplification and is fundamentally unfair to retailers.
  - A. The Agreement means enormous new obligations compared to the present system, so it is not simplification at all.
  - B. The number of tax jurisdictions isn’t reduced, and the number of tax rates could go even higher.
  - C. The Agreement does not require uniform definitions for taxable products.
  - D. The Agreement’s ‘uniform’ definition of ‘sales price’ permits every member state to use a different measure, so that the taxable amount of a sale transaction will differ from state to state.
  - E. The Agreement ignores its impact on consumers who order by mail and pay for their purchases by check. These customers are likely to be elderly and/or those with low income who cannot obtain credit cards.
  - F. The Agreement’s provisions concerning taxation of digital products are unworkable and unfairly expose retailers to liability.
  - G. The provisions for compensating retailers and certified service providers are woefully inadequate.
  - H. Retailers bear all the burdens of compliance, but received no protection from liability for tax collection errors.
  - I. The Agreement’s governance provisions allow the states to police themselves.

- J. The Agreement has no mechanism to guarantee consistency and uniformity over time.
- K. The Agreement allows no judicial review of Board decisions.
- L. The system envisioned by the SSTA is far from operational and certainly not ready to form the basis for expanded state tax jurisdiction.

IV. The states have failed to conform their laws to the Agreement.

- A. State legislatures consistently omit key provisions of the Agreement.
- B. States have renamed taxes and crafted other creative legislation to circumvent the Agreement's requirements.
- C. Conformity legislation is a vehicle for state tax increases.

V. The Agreement will have harmful, potentially disastrous, effects on the economy and American jobs.

- A. The SSTA will not 'level the playing field' between in-state and out-of-state merchants.
- B. The SSTA will hurt the competitiveness of American companies and favor foreign firms, hampering economic recovery and causing the loss of American jobs.

VI. Dire predictions of state revenue 'loss' from e-commerce are grossly overstated.

VII. If Congress expands state tax jurisdiction over interstate commerce, the Tax Injunction Act\* should be repealed and federal courts should have jurisdiction over tax disputes alleging violations of federal law.

## **COST REPORT CARD ON THE SSUTA AGREEMENT**

The Council on State Taxation (COST) issued its first report card on the SSTP's recommendations in November 2001 and its second one in November 2002.<sup>145</sup> The report cards compare the Agreement with COST's *Policy Statement on Simplification of the State and Local Sales and Use Tax System*. The report cards judge whether the requirements of the Agreement provide *radical* simplification of the current sales and use tax structure. The word *radical* is used because it conveys the level of change the organization feels is needed to simplify the extraordinarily complex sales tax system in the U.S.

Grades from the COST report cards, presented in Table 24, represent:

- A – Radical Simplification,
- B – Significant Simplification,
- C – Some Simplification,

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\* The Tax Injunction Act, 28 U.S.C. § 1341 provides that "[the] district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."

D – Insignificant Simplification,

F – Not addressed by the Agreement, no simplification, or new complexity, and

INC – Addressed by the Agreement, but too early to grade.

**Table 24**

<b>COST Report Card on SSTIS Agreement</b>		
<i>Category</i>	<i>2001 Grade</i>	<i>2002 Grade</i>
Uniform Tax Base Definitions	INC	B
Uniform Exemption Rules	A	A
Uniform and Centralized Administration	A-	B/INC
One Rate Per State	C+	B-
One Base Per State	B	B/INC
Uniform Sourcing Rules	B+	B+
Bad Debt Deduction/Refund	B	B
Uniform Direct-Pay Permits and Registration Requirements	INC	A
Technology Certification	C	B/INC
Hold Harmless	B-	A-
Vendor Allowance	INC	F/INC
Governance	F	A-/INC
Interpretation	F	A-/INC
Issue Resolution Process	NA	A-/INC
Replacement Taxes	NA	F
Expansion of Tax Base	NA	C
Source: <i>State Tax Notes</i> : December 3, 2001 and November 11, 2002.		

For some of the categories with low grades, summaries of COST's 2002 comments follow:

**Vendor allowance:** The Agreement fails to explicitly mandate reasonable vendor allowance for all vendors. Congress should not require remote collection without requiring that vendors receive a reasonable allowance to pay for the collection of the tax.

**Replacement Taxes:** The Agreement fails to discourage member states from shifting sales tax complexity onto other transaction taxes. For example, Minnesota generally exempts clothing but taxes clothing made from fur. Because the Agreement does not provide a separate definition for clothing made from fur, the state created a separate "fur tax" identical to the previous sales tax. The Agreement also allows states to exclude certain sales taxes. Thus it fails to prohibit states from employing tactics contrary to the goal of simplification.

**Expansion of Tax Base:** The Agreement fails to discourage member states from using simplification as a reason for expanding their tax base.

## TAX CARTEL (SSUTA) VS. TAX COMPETITION

A number of scholars have disagreed sharply with SSUTA proponents, especially regarding the use of destination-based taxes and the constitutionality of the SSUTA. A policy brief by the Americans for Tax Reform states, “every major free-market and pro-growth association opposes the SSTP. These groups include Americans for Tax Reform, the National Taxpayers Union, Citizens for a Sound Economy, Club for Growth, Citizens against Government Waste, the Cato Institute, the Heritage Foundation, the American Enterprise Institute and dozens of state-based think tanks across the nation. These groups oppose the adoption of the SSTP because the history of the movement does not support a commitment to tax neutrality, and because its present proponents cannot guarantee that the net impact on taxpayers in every state will be zero. Proponents of SSTP include state tax commissioners and their staffs, multi-state accounting firms, who stand to benefit from the compliance complexity SSTP induces, and tax-and-spend lawmakers desperate to ease the process of collecting taxes – so as to more easily increase taxes.”<sup>146</sup>

In a 2003 article by Adam Thierer and Veronique de Rugy (Cato Institute), the broad goals of the SSUTA are challenged: “The goal should be to move toward a system of consumption taxation that is both economically efficient and constitutionally permissible. And tax competition should be regarded as a virtue, not a drawback, within any new system... Although all the solutions on the table have a serious downside, a pure origin-based sourcing rule for all sales taxes presents an economically efficient and constitutionally sensible solution to the nagging tax ‘fairness’ and ‘neutrality’ concerns expressed by many policymakers and Main Street vendors. Moreover, an origin-based sourcing rule is vastly superior to a collusive multistate tax compact such as the SSUTA.”<sup>147</sup> The authors also note numerous alternatives to the SSUTA plan. Some alternatives are:

- Option 1: Enact a Multistate “Tax Simplification” Compact (such as the SSUTA).
- Option 2: Expand Efforts to Enforce Use Tax Collection.
- Option 3: Maintain the Status Quo.
- Option 4: Reinforce Current Nexus Guidelines.
- Option 5: Specifically Exempt All Internet Sales/E-Commerce from Sales/Use Taxes.
- Option 6: Provide Sales Tax Exemptions for Tangible Products with Digital Equivalents.
- Option 7: Reform Sales Tax Policies or End Exemptions to Broaden the Base.
- Option 8: Adopt a Uniform Origin-Based System of Sales Tax Collection.
- Option 9: Abolish All Sales and Use Taxes.
- Option 10: Adopt a Savings-Exempt Income Tax to Tax Individual Consumption.

A recent argument for an origin-based sales tax (Option 8) can be found in *Sell Globally, Tax Locally* by Michael Greve. The analysis argues against harmonizing the destination-based status quo because the proposed mechanisms “will not be nearly as efficient and equitable as their supporters hope (nor, candidly, quite as oppressive as their opponents fear). They will likely make sales taxation even more burdensome, complex and expensive, to little or no offsetting benefit.” Greve argues that origin-based taxation

enhances tax competition, which is preferable to the intergovernmental tax cartel arrangement produced by destination-based taxation.

Under any destination-based regime, governments typically find it impossible to collect consumption taxes from purchasers. Hence, they must use sellers as collection agents. This generates extravagant compliance costs and requires a high degree of inter-governmental cooperation. In the e-commerce context, this poses serious practical problems. The SSUTA, for example, tries to make destination-based taxation “work” for e-commerce through tax simplification, technological innovation (to reduce compliance and administrative costs), and enhanced intergovernmental cooperation and harmonization. Greve’s analysis shows that this proposed solution relies upon the existence of a benevolent and rational super-governmental body for which there is no precedent. Moreover, destination-based taxation cannot satisfy widely accepted principles of taxation, such as simplicity, neutrality among industries, and ease of administration, and in fact brings them into conflict.

Greve does not argue that origin-based sales taxation is more “efficient” than destination-based taxation, in the technical senses in which tax economists use that term. Tax economists place a high premium on “locational neutrality,” that is, the notion that the tax system should not unduly distort private economic decisions.<sup>148</sup> Greve is inclined to think that this argument owes its force chiefly to its high level of theoretical abstraction.

### **CBO SUMMARY: SHOULD REMOTE SELLERS BE REQUIRED TO COLLECT USE TAXES?**

In its October 2003 report, the Congressional Budget Office (CBO) summarized the debate on taxation and remote sales. According to one side or the other in the debate, requiring remote sellers to collect use tax will:

- Have opposing effects on the social costs of taxation – decrease the loss of national income when the differential taxation of commodities causes tax-motivated decisions about consumption and production (excess burden) and increase the compliance costs that would be imposed on remote sellers to collect and remit use taxes;
- Increase the size of government and eliminate a tax advantage that is helping the Internet grow to its economically desirable size;
- Distribute the burden of sales taxes more equitably and treat people in equal circumstances equally;
- Impose a tax burden on remote sellers who, unlike local sellers, receive no compensating public service benefits (for example, fire and police protection); or
- Compromise the fiscal autonomy of states and local governments, which is guaranteed by the Constitution, if standardization of tax bases and rates is required to reduce compliance costs.

Remote use tax collection reflects a trade-off between two kinds of social costs that arise from taxation: the loss of national income (1) from non-uniform taxation and (2) from incurring administrative and compliance costs for collection. The desirability of remote collection depends on the magnitudes of those two kinds of costs.

## EVALUATION OF THE SSUTA AGAINST OTHER SALES TAX REFORM PROPOSALS

The SSUTA is one of many sales tax reform proposals that have been considered in the past two decades. The analysis below summarizes Zodrow (2002) and Graham (2002).<sup>149</sup> Both authors group different reform proposals along a spectrum that is broadly defined by two philosophical approaches to reform: one approach would tax e-commerce and the other would not. Details of some of these proposals are listed on the next page. Various proposals are described online at: <http://www.ecommercecommission.org/proposal.htm>.

### I. SALES TAX REFORM PROPOSALS THAT WOULD TAX E-COMMERCE

The current sales tax suffers from numerous structural problems that have been exacerbated by the advent of electronic commerce. The focus of these reform proposals is on the inordinate complexity of the current system as well as the inefficiency and inequity of effectively providing preferential tax treatment of sales by remote vendors without nexus in the taxing state, relative to sales by local vendors or remote vendors with nexus.

Zodrow (2002) outlines sales tax simplification proposals along a spectrum ranging from fundamental reform of the entire system to a technological fix of the current one. The SSTP effort falls somewhere between these two proposals.

1. Fundamental Reform:  
Ideal Retail Sales Tax  
(Professor McLure)

2. SSTP

3. Technological Fix: State efforts to increase compliance with existing sales/use tax scheme, relying on computer software to deal with the complex system.

Graham (2002) groups pro-tax proposals that would pass constitutional scrutiny after *Quill*.

4. Direct congressional overruling of the *Quill* physical presence test and establish an economic presence test.

5. State compacts with federal endorsement (ex. SSTP)

6. State efforts to increase compliance with the existing sales/use tax scheme

### II. SALES TAX REFORM PROPOSALS THAT WOULD NOT TAX E-COMMERCE

The focus of this effort is to reduce the sales tax burden, either for certain transactions or industries (such as e-commerce) or, more generally, as a means of forcing a reduction in the size of state and local government

Graham (2002) gives examples of proposals that are against taxing e-commerce.

7. Exempt all Internet sales from taxation

8. Do nothing. Keep the current physical presence test from *Quill*.

9. Legislate: Codify and clarify the *Quill* physical presence standard by Congress.

## I. SALES TAX REFORM PROPOSALS THAT WOULD TAX E-COMMERCE

### 1. Fundamental Reform: Ideal Retail Sales Tax – Proposed by Professor McLure and public sector economists.

- Calls for comprehensive reform: a destination-based tax on consumption of final consumer goods and services,
- Radical simplification – uniform taxation of a consumption tax base,
- Promote economic growth – avoid taxes on business activity,
- Reduce administrative and compliance costs,
- Provide for efficiency in production and neutrality in consumption, and
- Not necessarily designed to increase revenue. Could be revenue neutral at the state level when implemented.

### 2. SSTP/SSUTA – Falls short of fundamental reform, but incorporates some elements of reform, simplification and technological fix.

### 3. Technological Fix –

- Leaves sales and use tax systems relatively unchanged but uses computer software programs to determine use tax liabilities on remote sales,
- Sophisticated computer interface to cope with the complexity of the existing tax system, thus facilitating compliance by remote vendors,
- Preserves independent tax authority of state and local governments,
- Little true simplification, and
- Relatively high compliance costs.

### 4. Economic Presence – Congress could overrule the *Quill* physical presence test and establish an economic presence test.<sup>150</sup> This would remove the focus of the nexus inquiry from asking if the vendor has any physical assets within the state to asking if the vendor engages in economic activity within the state.\* The legal aspects of this proposal are described in Buechler (1998).

### 5. State Compacts With Federal Endorsement

- 5a. SSTP/SSUTA
- 5b. National Sales Tax: Proposed by Senator Ernest F. Hollings, D-S.C. in 1999 (S 1433, 106<sup>th</sup> Congress). This federal sales tax was to be collected on all remote

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\* There are two types of economic presence: first-sale economic nexus and substantial economic presence. First-sale economic presence would expand state power to require remote vendors to collect and remit a use tax to the limits allowed by the Due Process Clause. The state would have the requisite nexus after an Internet vendor made one sale in its jurisdiction. Under a substantial economic presence standard, a state would have jurisdiction over a remote vendor if the vendor had substantial sales in the state. “Substantial” could be defined as a certain number of transactions within the jurisdiction or a minimum value of purchase.

sales, allowing a credit for any sales tax paid. The federal government could either distribute the collected tax back to the states or keep and spend it as general revenue.\*

6. Increase Compliance With the Existing Sales/Use Tax Scheme: One example of a state effort to increase compliance is the “Maine Approach,” which adds a line for use tax on the state income tax return.

II. REDUCE SALES TAX BURDEN – As a general example of an anti-e-commerce tax proposal, Zodrow (2002) gives the “Majority Proposal” of the 2000 Advisory Commission on Electronic Commerce.<sup>†</sup> This proposal:

- Extended the scope of the current *de facto* exemption of remote sales.
- Made it more difficult for states to assert the existence of nexus.
- Proposed a single rate per state, which would eliminate all local rate flexibility, and uniform base definitions.

7. Exempt All Sales of Internet Purchases From Taxation – This plan would require congressional legislation that would permanently prohibit imposing a sales tax on any goods sold over the Internet. This proposal would overrule *Quill* by not allowing a state to levy a tax on an Internet sale even if the e-retailer also had a physical presence in the state.<sup>‡</sup>

8. Do Nothing. Keep Current Physical Standard Test.

9. Legislative Solution: Codify and Clarify the *Quill* Physical Presence Standard – Dean Andal, former California Board of Equalization member, proposed to create a single uniform jurisdictional standard for taxing interstate commerce: substantial physical presence. It “incorporates a series of safe harbors that ensure the Internet does not become the occasion for state and local governments to attempt to create an ever-expanding list of activities that might arguably create taxable nexus.”<sup>§</sup>

### ***Evaluation of Different Sales Tax Reform Proposals***

Table 25 shows one example of an evaluation of various sales tax reform proposals. Graham (2002) notes that to rank these policies in a reasoned way, estimates that do not exist are needed, such as (1) the real economic loss caused by not taxing Internet sales;

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\* A current national sales tax proposal (Linder, R-GA., HR 25) would repeal individual and corporate income taxes and Social Security payroll taxes and replace them with a sales tax of 23 percent of all sales of goods and services for final consumption in the U.S.

<sup>†</sup> In March 2000, the U.S. Advisory Commission on Electronic Commerce (ACEC) sent a majority report to Congress. This Commission was created by the Internet Tax Freedom Act of 1998. The panel was not able to make recommendations on many of the major issues because the required 2/3 majority vote was not obtained.

<sup>‡</sup> John Kasich, *Internet Tax Elimination Act*, <http://www.ecommercecommission.org/proposal.htm>.

<sup>§</sup> Dean Andal, *A Uniform Jurisdictional Standard a*, <http://www.ecommercecommission.org/proposal.htm>.

(2) the total compliance costs of remote vendors if they were required to collect use tax; and (3) Gross Domestic Product (GDP) growth with and without requiring use tax collection.

Evaluations of sales tax reform proposals have been published by many other authors. Joint Venture Silicon Valley, for example, has compared the Streamlined Sales Tax Project with other sales tax reform efforts.<sup>151</sup> Benjamin Russo surveys proposed solutions to sales and use tax conundrums in a November 2002 *State Tax Notes* article.<sup>152</sup>

**Table 25**

<b>Graham (2002): Evaluating the Proposals According to Policy Objectives</b>					
<b>Proposal</b>	<b>Protecting state revenue</b>	<b>Taxes don't determine low-cost provider</b>	<b>Low compliance costs</b>	<b>Encourage Internet growth</b>	<b>Respect state sovereignty to tax</b>
<b>Pro-Tax</b>					
4. Economic Nexus	+	+	-	-	+
5a. National Sales Tax	-	+	+	-	-
5b. SSTP	+	+	0	0	+
6. Maine Approach*	0+	0+	0+	+	0+
<b>Anti-Tax</b>					
7. Exemption	-	-	+	+	-
8. Do Nothing	0	-	0	0	-
9. Legislate <i>Quill</i>	0	-	+	+	-
KEY: + proposal advances policy; - proposal hinders policy; 0 no effect.					
* The "Maine Approach" refers to state efforts to increase use tax compliance, such as adding a line for use tax on the state income tax return.					
Source: Matthew Graham, <i>State Tax Notes</i> , September 2, 2002.					



## DIFFERENCES IN SALES TAX REVENUES ACROSS STATES

Differences in sales tax rates and bases result in large variations across states with regard to the amount of sales tax revenues collected. In this section, California's sales and use tax data are compared with the national average using the following criteria:

1. State sales tax rate.
2. Sales tax reliance: Adjusted state sales taxes as a percentage of total tax revenue.
3. Sales tax burden: Per capita state sales tax revenue, both in total and as adjusted for the prevailing state rate.
4. Sales tax effort: State sales tax receipts as a percentage of state personal income.
5. Sales tax breadth: State sales tax base as a percentage of state personal income.
6. Number of service categories taxed.
7. Sales tax composition: Local sales tax revenue as a percentage of state and local sales tax revenue.

The analysis relies heavily on work published in *State Tax Notes* by Professor J. Mikesell of Indiana University. The state sales tax data were produced by the Governments Division of the U.S. Bureau of the Census<sup>153</sup> and adjusted to make them comparable across states by Professor Mikesell (see Appendix K). The Census Bureau collects data according to the legal definitions of the sales tax in each state, but these definitions can vary widely. In 2002, Professor Mikesell made adjustments for 19 of the 45 states with a sales tax; in 2003, data for 27 states were adjusted; data for California did not require adjustments. Sales tax data are in Appendices E, F, K, L and M.

In summary, in 2003 California ranked **below** the national average for reliance, burden (adjusted for rate), effort, breadth, and number of service categories taxed; the state ranked **above** the national average for the state sales tax rate, burden (unadjusted for rate) and composition (percent local in 2000). States that have already conformed their laws to the SSUTA tend to be smaller population states and/or states that are heavily reliant on sales tax revenues. At the end of the section, sales tax characteristics are reviewed for states that have been slow, or in some cases resistant, to joining the SSTP process, such as California, New York, Colorado, Georgia, Idaho, New Mexico and Hawaii.

### *State Sales Tax Rates*

As Professor Mikesell has noted, state financial problems often create a political climate in which increases in statutory rates become a viable alternative.<sup>154</sup> Table 26 shows that from 1980 to 2004, the mean state sales tax rate (among those states that adopted a state sales tax) increased 1.38 percentage points, from 3.93 percent in 1980 to 5.31 percent in 2004. The increase in rates over this period has not been uniform. In many states, rates were increased during recessions in the early 1980s, early 1990s and since the downturn in 2001. Rates were basically flat in the late 1990s. In January 2004, state rates ranged from 2.9 percent in Colorado to 7.0 percent in Tennessee, Mississippi and Rhode Island. From 1980 to 2004, the California state sales tax rate has been above the national

average; in July 2004, the state rate was increased to 6.25 percent. A detailed discussion of the California sales and use tax rate is in Appendix L.

**Table 26**

<b>Distribution of State Sales Tax Rates, January 1980 Through January 2004</b>					
	1/1/1980	1/1/1990	1/1/1995	1/1/2000	1/1/2004
California State Rate	4.75%	5%	6%	6%	6%
Mean Rate (States)	3.93%	4.87%	5.16%	5.16%	5.31%
Number of States with Rates of 6% or Higher	3	11	17	16	20
Range: Low	2% (OK)	3% (CO)	3% (CO)	3% (CO)	2.9% (CO)
High	7% (CT)	7% (CT)	7% (MS, RI)	7% (MS, RI)	7% (TN, MS, RI)
Source: John Mikesell, <i>State Tax Notes</i> , July 12, 2004, p. 131. On July 1, 2004, the California state rate increased to 6.25% (see Appendix L).					

### ***State Sales Tax Reliance***

At the national level, reliance on the sales tax, as measured by state sales tax revenues as a percent of total tax revenues, was flat at about 35 percent from 1990 to 2003; reliance in California was around 31 percent (see Table 27). In general, increases in rates have been offset by erosion of the sales tax base. California's reliance on the sales tax decreased in the late 1990s due to large increases in income tax revenues.

Sales tax reliance varies enormously across the states. These differences are due to the legal definition each state uses for its sales tax base, the statutory rate applied to this base, the administrative effort applied to tax enforcement, and the economic nature of the state, including the affluence of the population. Rankings for 2003 state sales tax indicators are shown in Table 28. Sales tax reliance ranged from about 20 percent in New York and Vermont to 60 percent in Texas and Tennessee.\* In general, sales tax reliance was especially high in states that levied no individual income tax, such as Texas, Tennessee,<sup>†</sup> Florida, Nevada and South Dakota. Reliance was particularly low in states that aggressively tax income, such as Massachusetts and New York. States in New England and the Mid-Atlantic relied less on the sales tax than states in the West and Far West.

### ***State Sales Tax Burden***

Sales tax revenues per capita, both in total and adjusted for the prevailing state tax rate, indicate the tax burden. In 2003, the national average per capita sales tax revenue was \$688; California's sales tax burden was slightly above average, at \$702 per capita. The 2003 rankings in Table 28 show that the highest per capita collections were in Hawaii, Washington and Nevada – states with combinations of relatively broad sales tax bases

\* The use of adjusted sales tax data changes the ranking of many states. Using 2003 unadjusted data, Washington had the highest sales tax reliance, 61.8 percent. Using adjusted data, Washington had reliance of 46.3 percent and was ranked ninth.

<sup>†</sup> Tennessee taxes only interest and dividend income.

(fewer exemptions of commodities and broader coverage of services) and tourist-destination economies. States with lower-than-average statutory tax rates (Colorado, Alabama, Oklahoma, New York and Virginia) were at the low end of the per-capita collections. When the influence of statutory rates is removed by calculating per capita yield per one percentage point of rate, states with broad bases and tourist economies remained highest, but states with generous exemptions (Rhode Island, Pennsylvania and Oklahoma) tended to be lowest.<sup>155</sup> When the effect of the higher sales tax rate in California is removed, the state's adjusted burden was \$117 in 2003, below the national average of \$131. From 1990 to 1995, California's adjusted burden remained at \$93 per capita.

**Table 27**

<b>State General Sales Tax Indicators, California and the U.S., 1990 to 2003</b>								
	1990	1995	2000	2002	2003	Percentage Growth		
						1990-95	1995-00	2000-03
<b>Adjusted State Sales Tax Revenue (\$ billions)</b>								
CA	\$13.6	\$17.7	\$23.5	\$23.8	\$24.9	30%	33%	6.0%
USA	\$100.3	\$135.3	\$178.6	\$183.0	\$189.1	35%	32%	5.9%
<b>Total State Tax Revenue (\$ billions)</b>								
CA	\$43.4	\$53.3	\$83.8	\$77.8	\$79.2	23%	57%	-5.5%
USA	\$293.6	\$391.2	\$526.5	\$521.7	\$546.7	33%	35%	3.8%
<b>Sales Tax Reliance (= state sales tax revenue as a % of total state tax revenue)</b>								
CA	31.3%	33.2%	28%	30.6%	31.4%			
USA	35.5%	35.7%	35.3%	35.1%	34.1%			
<b>Total Sales Tax Burden (= per capita state sales tax revenues)</b>								
CA	\$456	\$560	\$690	\$680	\$702	23%	23%	1.7%
USA	\$419	\$546	\$653	\$652	\$688	30%	20%	5.3%
<b>Sales Tax Burden Adjusted for Rate (= per capita state sales tax revenues per 1% rate)</b>								
CA	\$93	\$93	\$115	\$113	\$117	0%	24%	1.7%
USA	\$87	\$107	\$128	\$129	\$131	23%	20%	2.5%
<b>Sales Tax Effort (= state sales tax revenue as a % of personal income)</b>								
CA	2.3%	2.3%	2.4%	2.1%	2.1%			
USA	2.6%	2.5%	2.1%	2.1%	2.3%			
<b>Breadth of Base (= implicit state sales tax base as a % of personal income)</b>								
CA	48.1%	38.8%	39.4%	36.1%	34.7%			
USA	51.3%	48.8%	48.2%	45.1%	43.3%			
<b>Sales Tax Composition (= local general sales tax revenue as a % of total [local + state])</b>								
CA	20.3%	18.7%	22.9%	NA	NA			
USA	17.8%	17.4%	18.9%	NA	NA			
See Appendix K for an explanation of the state sales tax adjustments. The state sales tax data are from the U.S. Census Bureau (State Tax Collection Data by State) and were adjusted by Professor J. Mikesell. Source: John Mikesell, <i>State Tax Notes</i> , Feb. 3, 1997, Feb. 10, 2003, Nov. 10, 2003, July 12, 2004; Author's calculations. Tax revenues used to calculate composition were not adjusted. Source: U.S. Census Bureau <a href="http://www.census.gov/govs/www/estimate00.html">http://www.census.gov/govs/www/estimate00.html</a> . Population and personal income data are from the Bureau of Economic Analysis. Calendar year 2003 = Fiscal Year 2002-03								

Table 28

State Sales Tax Indicator Rankings – 2003 (FY 02-03)									
Rank	Tax Reliance		Tax Burden			Tax Effort		Tax Breadth	
	(1) SUT to Total Revenue (%)		(2) SUT Revenue per Capita (\$)		(3) SUT per Capita, Adjust for Rate (\$)	(4) SUT Receipts to Personal Income (%)		(5) SUT Base to Income (%)	
1	TN	61.4	HI	1,357.9	HI 339.5	HI	4.4	HI	109.8
2	TX	59.8	WA	979.6	WY 212.1	MS	3.6	WY	64.6
3	FL	56.0	NV	978.2	NM 159.1	TN	3.3	NM	62.3
4	NV	53.1	MN	969.3	SD 158.1	NV	3.1	LA	59.2
5	MS	49.8	TN	926.9	LA 154.4	NM	3.1	AR	57.5
6	AZ	49.3	FL	886.0	WA 150.7	AR	2.9	SD	54.1
7	SD	47.9	CT	880.0	NV 150.5	WA	2.9	UT	53.3
8	HI	47.8	MS	855.3	MN 149.1	FL	2.9	MS	52.1
9	WA	46.3	WY	848.4	NE 148.5	AZ	2.9	AZ	51.1
10	NE	42.4	NE	816.7	FL 147.7	MN	2.8	FL	48.5
11	NM	41.3	NM	795.4	CT 146.7	TX	2.7	NE	48.3
12	SC	40.6	TX	787.1	AR 139.7	NE	2.7	NV	48.1
13	AR	37.9	AZ	768.3	CO 138.9	KY	2.6	ID	47.6
14	KS	37.7	MI	759.2	AZ 137.2	WY	2.6	SC	47.5
15	UT	37.6	AR	716.0	WI 136.7	WV	2.6	ND	46.5
16	IN	37.5	RI	712.6	GA 136.4	UT	2.5	TN	46.5
17	LA	37.3	CA	701.7	ND 135.7	MI	2.5	GA	46.3
18	MN	36.6	KS	693.4	UT 133.1	ID	2.4	ME	45.6
19	ND	36.5	NJ	687.2	TN 132.4	SC	2.4	WA	45.2
20	ID	35.9	KY	684.8	ME 131.3	LA	2.4	WI	44.3
21	GA	35.3	WI	683.7	KS 130.8	IN	2.4	KS	43.7
22	WY	34.9	IN	679.6	VA 127.9	ND	2.3	KY	43.5
23	IA	34.1	ND	678.4	MI 126.5	KS	2.3	MN	43.3
24	RI	34.0	ME	656.7	TX 125.9	ME	2.3	WV	43.0
25	KY	33.9	UT	632.4	MD 125.6	RI	2.2	TX	42.9
26	MI	33.6	SD	632.3	SC 124.2	WI	2.2	MI	41.6
27	OH	32.7	WV	629.3	ID 123.3	SD	2.2	CO	40.5
28	MO	32.7	MD	628.1	MS 122.2	CA	2.1	IA	40.4
29	PA	32.6	SC	621.2	OH 118.3	CT	2.0	AL	40.0
30	CT	32.2	LA	617.5	IA 117.3	IA	2.0	MO	40.0
31	ME	31.8	ID	616.3	MO 117.0	OH	2.0	OH	39.5
32	WV	31.7	PA	611.5	CA 116.9	PA	1.9	IN	39.3
33	MD	31.5	OH	591.3	MA 115.3	GA	1.9	NC	37.4
34	CA	31.4	IA	586.6	NJ 114.5	NJ	1.7	OK	35.7
35	WI	30.7	MA	576.4	KY 114.1	MO	1.7	CA	34.7
36	IL	29.9	GA	545.7	IN 113.3	MD	1.7	CT	34.0
37	NJ	29.8	IL	522.7	NY 110.8	NC	1.7	RI	34.0
38	AL	29.5	VT	511.9	NC 105.5	VT	1.7	MD	33.6
39	CO	27.6	MO	494.3	AL 105.2	OK	1.6	VT	33.3
40	VA	25.5	NC	474.9	WV 104.9	AL	1.6	PA	31.8
41	OK	25.5	VA	447.6	VT 102.4	IL	1.6	NY	30.3
42	NC	25.2	NY	443.3	PA 101.9	MA	1.4	MA	29.0
43	MA	23.8	OK	428.2	RI 101.8	VA	1.3	NJ	28.3
44	NY	21.0	AL	421.0	OK 95.1	NY	1.2	VA	25.5
45	VT	20.3	CO	402.8	IL 83.6	CO	1.2	IL	24.8
	U.S.	34.1	U.S.	687.5	U.S. 131.2	U.S.	2.3	U.S.	43.3

Source: John L. Mikesell, *State Tax Notes*, July 2004 and author's calculations. 2003 Preliminary Personal Income and Population data are from the Bureau of Economic Analysis, April 27, 2004.

### ***Sales Tax Effort***

Tax effort can be measured using sales tax *revenues* as a percentage of personal income.\* California's state sales tax *revenues* as a percent of personal income were 2.1 percent in 2003, just slightly below the national average of 2.3 percent. Hawaii, Mississippi, Tennessee, New Mexico and Nevada had an average sales tax effort of 3.5 percent, in contrast to the 1.3 percent raised by the states with the lowest effort (Colorado, New York, Virginia, Massachusetts and Illinois).

### ***Breadth of Sales Tax Collection***

The breadth of sales-tax collection can be measured by the implicit sales tax *base* as a percentage of personal income. The size of the sales tax base depends on the rates as well as the coverage of the tax. States design their sales tax laws to include and exclude a wide variety of transactions. Appendix E lists some of these exemptions by state. Almost all states tax manufactured goods and exempt prescription drugs. Some states exempt food purchases for home consumption, some don't. Some states tax a wide range of services, some don't tax any. States with broad sales tax structures have higher taxed shares of personal income than those with narrower structures. California's share was a relatively low 34.7 percent in 2003 compared to the national mean of 43.3 percent. The broadest tax states (Hawaii, Wyoming, New Mexico, Louisiana and Arkansas) averaged a taxed share of personal income equal to 71 percent, compared with an average of 28 percent for the five narrowest tax states (Illinois, Virginia, New Jersey, New York and Massachusetts).

### ***Sales Tax Composition: State and Local***

What is the composition of state and local sales tax revenue? In Table 29, the percent of total sales tax revenue received from local sources in fiscal 1999-2000 is indicated. For the United States as a whole, local sales taxes accounted for about 19 percent of total general sales tax revenue. In California, 23 percent of sales tax revenues were locally levied. Three states, Colorado, Louisiana and Alaska, had more than 50 percent of their general sales tax revenues from local sources. State and local tax rates are listed in Appendix M. Four states did not have any type of sales tax: Delaware, Montana, New Hampshire and Oregon. Alaska had no state sales tax, but did levy a local tax. Fourteen states had only state sales taxes and did not levy a local sales tax.† The District of Columbia levied a local sales tax in FY 99-00.

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\* Sales tax effort can also be calculated as state sales tax revenue per \$1,000 of personal income; this calculation is basically the same as Professor Mikesell's percentage calculation with a shift in the decimal point. In the *California Statistical Abstract* Tables P-5 and P-12, state tax effort is published using unadjusted census figures. In recent years, for sales tax effort, California ranks slightly above the U.S. average using unadjusted Census data and slightly below average using the data adjusted by Professor Mikesell.

† The 14 states with no local sales tax revenue were: Connecticut, Hawaii, Idaho, Indiana, Kentucky, Maine, Maryland, Massachusetts, Mississippi, Michigan, New Jersey, Rhode Island, Vermont and West Virginia.

**Table 29**

<b>Sales Tax Composition – Local Sales Tax Revenue as a Percent of Total (State + Local) Sales Tax Revenue, Fiscal Year 1999-2000</b>											
Rank			Local (%)			Rank			Local (%)		
1	Alaska	100.0	12	California	22.9	22	Nebraska	15.5			
2	Louisiana	52.3	13	Utah	22.7	23	North Dakota	13.4			
3	Colorado	51.0	14	Arkansas	22.4	24	Washington	13.2			
4	New York	48.0	15	South Dakota	22.2	25	Illinois	12.1			
5	Alabama	40.7	16	Tennessee	22.0	26	Iowa	9.0			
6	Oklahoma	40.0	17	Kansas	21.3	27	Nevada	5.8			
7	Georgia	38.5	18	Wyoming	20.5	28	Wisconsin	5.1			
8	Missouri	32.1	19	New Mexico	19.6	29	South Carolina	3.9			
9	North Carolina	25.3	20	Texas	19.2	30	Florida	3.5			
10	Arizona	25.1		<b>United States</b>	<b>18.9</b>	31	Pennsylvania	2.3			
11	Virginia	23.1	21	Ohio	15.7	32	Minnesota	0.9			

Source: U.S. Census, State and Local Government Finances, 1999-2000.  
<http://www.census.gov/govs/www/estimate00.html>

***Summary for States Slow or Reluctant to Join the SSTP***

A heavy reliance on sales taxes as a source of state revenue seems to be an important factor in whether a state became involved in the early stages of the SSTP. The states most reliant on state sales taxes are those that do not levy an income tax such as Texas, Tennessee, Florida, Nevada and South Dakota and all of these states have been actively involved in the SSTP process. Among the 18 states named to the Conforming States Committee, only Oklahoma, North Carolina and Vermont relied on sales taxes for less than 30 percent of their total tax revenue in 2003. In addition, many of the states initially involved were relatively low-population states with sales tax systems that were not as large and complex as those of states with larger populations.

Heavy reliance on local sales taxes or local administration of state taxes, as in Alabama, tends to make compliance with the SSUTA more difficult. In fiscal 1999-2000, six states relied on local sales taxes for more than 35 percent of their sales tax revenue: Alaska, Louisiana, Colorado, New York, Alabama, Oklahoma and Georgia. With the exception of Oklahoma, which has passed conforming legislation, these states have all been slow to join the SSTP process. Colorado has a complex local tax system with local tax bases that differ from the state base and has made it clear it currently does not plan to participate in the SSTP effort.

As of July 2004, the following seven states have been slowest to participate in the SSTP: Colorado was not participating; Idaho and New Mexico were not voting participants; New York, Hawaii, Georgia and California had only recently joined. Do these seven states have sales tax characteristics in common? Patterns are not clear-cut. For

state/local sales tax composition in FY 99-00, Colorado, New York and Georgia had a large percentage of their sales tax revenues from the local sales tax (between 38 and 52 percent); California and New Mexico had above average percentages (about 20 percent); Idaho and Hawaii had no local sales tax. For tax reliance, burden, effort and breadth in 2003, Hawaii and New Mexico had very high percentages (these states do not levy conventional retail sales taxes, however); New York, Colorado and California had low percentages almost across the board. Georgia and Idaho tended to straddle the middle for these measures.

### ***Number of Service Categories Taxed***

The number of services subject to tax varies greatly across states. Table 30 shows taxable service categories for a wide variety of services in the five most populous states as well as in the six states with the highest number of services taxed. The maximum number of services taxed in any one category is shown in the last line. In 1996, California taxed only 13 services compared with the 157 services taxed in Hawaii. Other large states also taxed significantly more services than California: Florida (64), New York (74) and Texas (78).

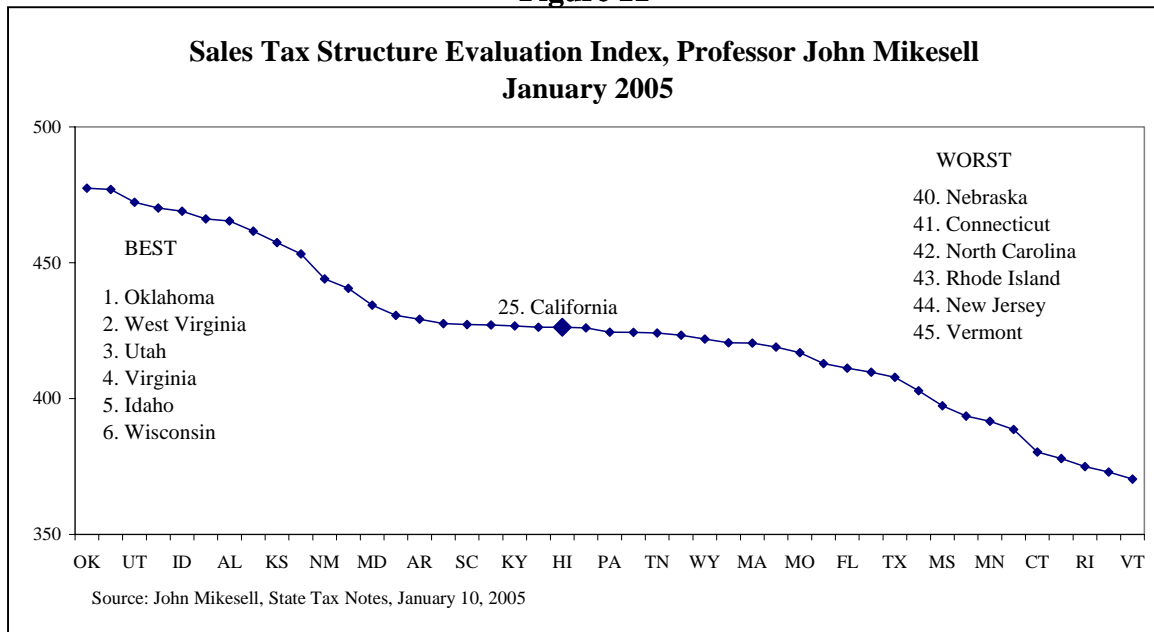
**Table 30**

<b>Taxable Service Categories for a Wide Variety of Services</b>									
	Utilities	Personal Services	Business Services	Computer Services	Ad./Am.*	Prof. Services	Fabric Repair, Install.	Other Services	Total
<b><i>Most Populous States:</i></b>									
California⊗	5	2	3	0	0	0	0	3	13
Illinois	12	1	1	1	0	0	1	1	17
Florida	7	4	8	2	13	0	16	14	64
New York	9	5	15	4	7	0	16	18	74
Texas	12	11	14	6	10	1	11	13	78
<b><i>States Taxing Many Services:</i></b>									
W. Virginia	10	17	26	4	13	1	13	26	110
S. Dakota	12	19	28	6	12	4	18	42	141
Delaware*	9	20	33	6	10	8	19	37	142
Washington*	16	20	34	6	10	8	15	43	152
New Mexico*	16	20	32	6	13	8	18	39	152
Hawaii*	16	20	34	6	13	8	18	42	157
<b><i>Maximum</i></b>	<b>16</b>	<b>20</b>	<b>34</b>	<b>6</b>	<b>14</b>	<b>8</b>	<b>19</b>	<b>47</b>	<b>164</b>
Data Source: Federation of Tax Administrators, Sales Taxation of Services Survey, 1996 <a href="http://www.taxadmin.org/fta/pub/services/services.html">http://www.taxadmin.org/fta/pub/services/services.html</a> ⊗ In California, some of these "services" are considered to be part of a sale of tangible personal property. *Ad. – Admissions/ Am. – Amusement. Includes business license tax in Delaware, business occupation tax in Washington, gross receipts tax in New Mexico and general excise tax in Hawaii. Delaware imposes no general sales tax, but assesses a 0.4 percent gross receipts tax on most businesses. Washington taxes many services through its occupation tax – 93 services are taxed at a rate below the general sales tax rate.									

## Sales Tax Structure Evaluation Index

Professor Mikesell has calculated an evaluation index of state sales tax structures against a standard structure that would embody desirable tax policy.<sup>156</sup> The index calculation involves a series of value judgments on first, which sales tax characteristics are important; second, how to measure sales tax structures against those characteristics; and third, how to weight the characteristics. The “best” state sales tax structures have low statutory rates; exclude business purchases from the base; exempt purchases of agricultural inputs; include all household consumption expenditures as well as household purchases of services and intangible personal property in the base; exempt the purchases of nonprofits and tax their sales; and are classified as vendor privilege taxes. Using Professor Mikesell’s index, California ranks near the middle of the 45 states with a sales tax.

**Figure 11**



## Tax Tunes, “The Day the Sales Tax Died”

In 2000, the National Tax Association held a conference on e-commerce. Billy Hampton, Deputy Comptroller of Texas, summed up his frustration with the shrinking sales tax base by dedicating the following song to the sales tax (sung to the tune of “American Pie”):<sup>157</sup>

*A long, long time ago  
I can still remember  
How the sales tax used to make me smile.  
I can't remember if I cried  
When I watched as the ACEC fried,  
But something touched me deep inside  
The day the sales tax died.*

*And we were singin'  
Bye, bye to the sales tax pie  
Tied our budget to the levy  
But the levy ran dry  
And Budget Committee chairs  
Were heaving dot.com sighs  
The day the sales tax died.*

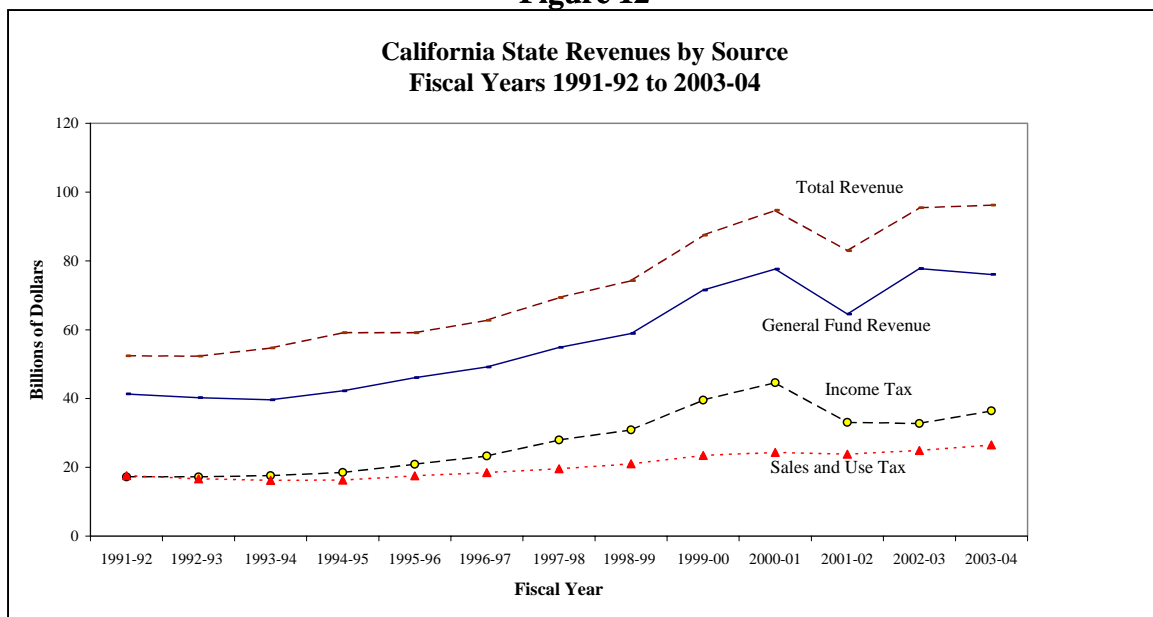
## CALIFORNIA SALES TAX TRENDS

This section provides statistical information on changes in California sales tax revenues over time using many of the same measures as the state-to-state comparison. California sales and use tax revenues totaled \$35.7 billion in fiscal 2002-03, including:<sup>158</sup>

- \$27.2 billion from the state sales tax, with
  - *\$22.6 billion allocated to the state's General Fund*
  - *\$2.28 billion allocated to the state's Local Revenue Fund*
  - \$2.28 billion allocated to the Local Public Safety Fund
- \$5.66 billion from the Bradley-Burns Uniform Local Sales and Use Tax
- \$2.90 billion in special district transactions sales and use tax

The two italicized categories, referred to as “state sales and use tax revenues,” are shown in Figure 12 for the past 12 years. Compared to the income tax, sales tax revenues look flat. The different tax rates imposed on each sales tax category are shown in Appendix L.

**Figure 12**

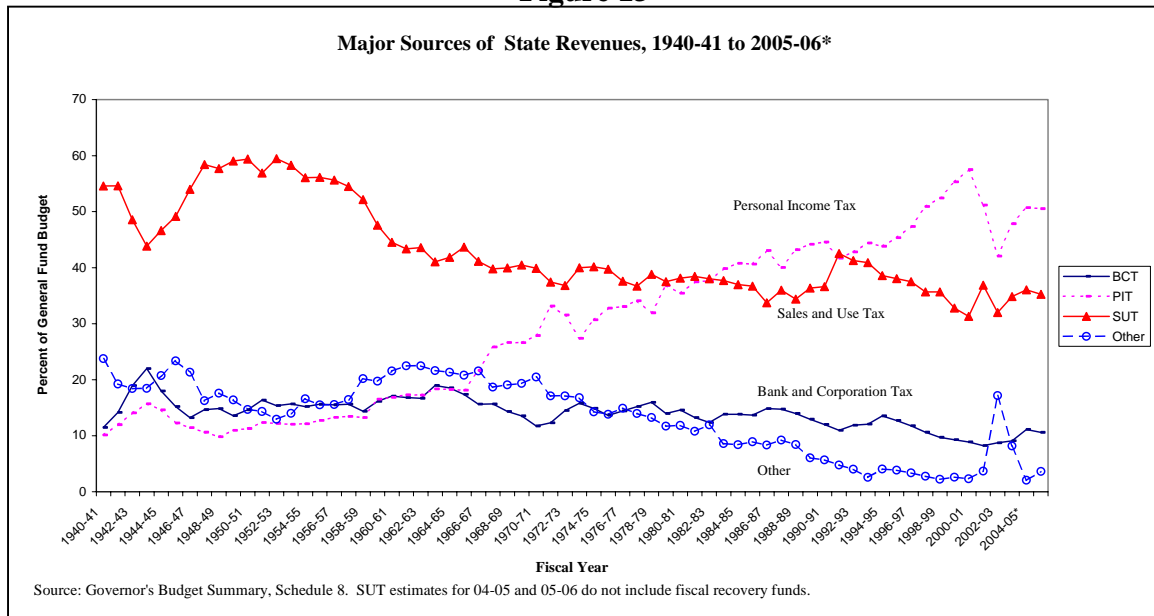


During the recession in the early 1990s, state sales and use tax revenues declined slightly. From 1994-95 through 2000-01, sales tax revenues increased each year. Between 2000-01 and 2001-02, however, General Fund revenues declined by about \$13 billion, mostly due to an \$11 billion drop in personal income tax revenues. State sales and use tax revenue totaled \$24.3 billion in 2000-01 and dropped to \$23.8 billion in 2001-02. Both income and sales tax revenues increased from 2002-03 to 2003-04.

## Sales Tax Reliance

Over time, funding sources for state revenues have changed dramatically. The biggest shift has been the rise in the personal income tax, which increased from 10 percent of state revenues in 1940 to about 50 percent in 2002 (see Figure 13). This rise has been offset by a decline in the relative shares of both the corporate income tax and the sales and use tax. In the 1940s and 1950s, sales tax revenues accounted for 55 to 60 percent of state revenue. Through the 1960s and 1970s, sales tax revenues were about 40 percent of state revenue. In fiscal year 2003-04, only about 34 percent of California's revenues were provided by the sales and use tax.

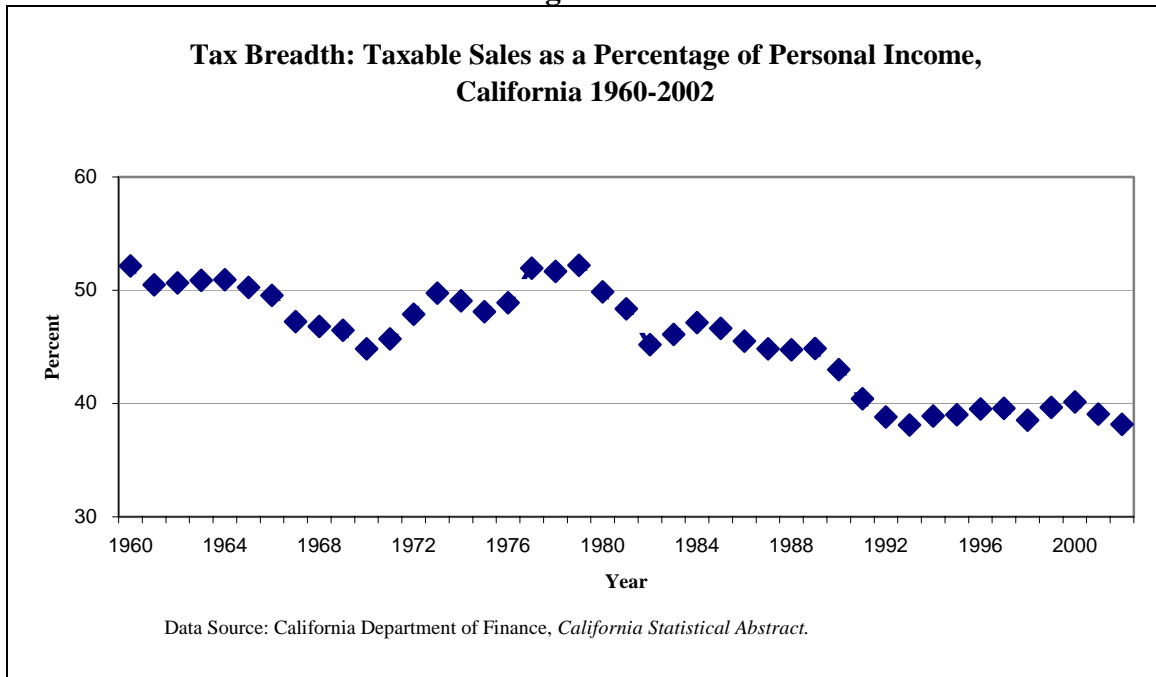
**Figure 13**



## Sales Tax Breadth and Effort

State-to-state comparisons showed that California has a relatively narrow sales-tax base. Few services are taxed and exemptions are relatively numerous. Over the past 40 years, the sales tax base has steadily eroded. Figure 14 shows that California sales tax *base* (taxable sales) declined as a percentage of personal income from about 50 percent from 1960 to 1980 to about 40 percent from 1992 to 2002. After adjusting for changes in sales-tax rates over time, the trend for sales-tax effort (i.e. sales tax *revenues* as a percentage of personal income) would have basically the same shape as this sales-tax breadth chart.

**Figure 14**



***Growth in Per Capita Sales Tax Revenue, Taxable Sales and Personal Income***

Table 31 shows growth in selected per capita measures from 1995 through the boom in the late 1990s and to the recession 2001 and 2002. Sales tax burden as measured by per capita state sales tax revenue increased by about 32 percent between 1995 and 2002, the same growth as taxable sales per capita; in comparison, personal income grew about 37 percent. After adjusting for inflation, real sales tax revenue and taxable sales per capita grew only nine percent; comparable real personal income growth was higher, about 13 percent.

**Table 31**

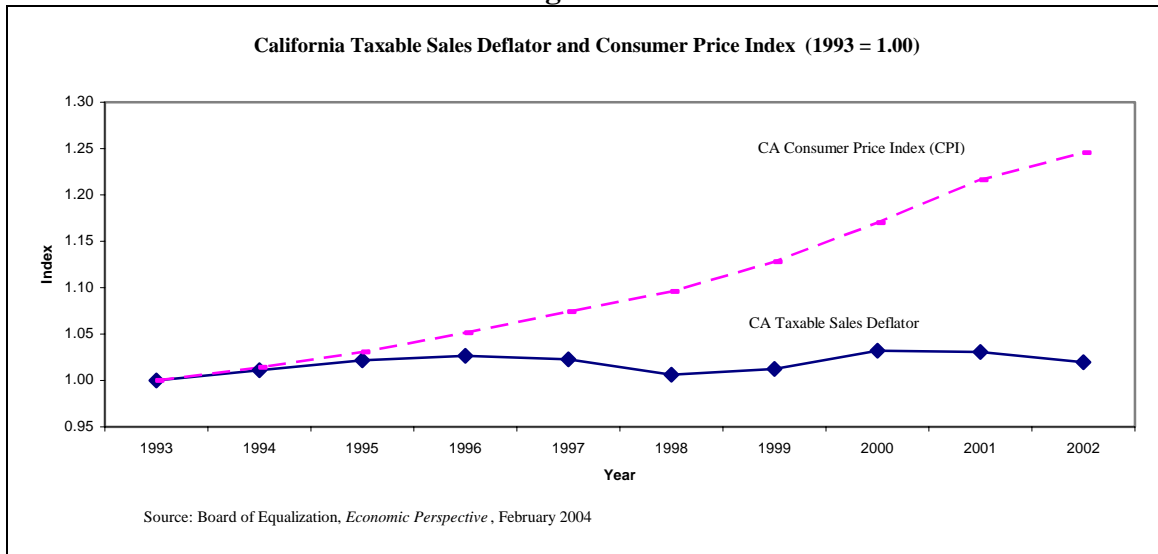
<b>Per Capita State Sales Tax Revenue, Taxable Sales and Personal Income: 1995-2002</b>			
	<b>Tax Burden: Sales Tax Revenue Per Capita</b>	<b>Taxable Sales Per Capita*</b>	<b>Personal Income Per Capita*</b>
FY 1994/95	\$515	\$9,491	\$24,161
FY 2001/02	\$681	\$12,491	\$32,989
1995 - 2002 % Growth	32%	32%	37%
1995 - 2002 % Real Growth	9%	9%	13%**
Data Sources: State Sales Tax Revenue and Taxable Sales: California Statistical Abstract, 2003, Table M-10 and K-4. Due to rounding and different data sources; these estimates differ slightly from those reported in Table 27 of this report. Sales tax revenue, taxable sales and personal income were deflated using the California Consumer Price Index. Population data: California Statistical Abstract, 2003, Table B-1. Per Capita Personal Income: U.S. Department of Commerce, Bureau of Economic Analysis, April 27, 2004. * Calendar year 1995 and 2002. **Calculations of real growth vary depending on the deflator used. For consistency, the California CPI is used in Table 31 for all three series. Using the personal consumption deflator, real personal income per capita grew by 21 percent from 1995 to 2002.			

### ***Taxable Goods Prices Increased Little Over the Past 10 Years***

Another reason for sales tax base erosion over the past decade is that prices of taxable goods have risen more slowly than prices of all consumer goods. A February 2004 Board of Equalization (BOE) analysis shows that California consumer prices increased about 25 percent from 1993 to 2002, while prices of goods subject to sales and use taxes increased only about two percent.<sup>159</sup> Figure 15 illustrates these trends. The analysis highlights two important economic and policy implications that can be drawn from having so little change in the prices of taxable goods since 1993.

- First, from the state and local government perspective, sales and use tax revenues and audit assessments have not increased very much from inflation over the past 10 years. If the taxable sales deflator is an accurate measure of prices, nearly all revenue growth over this period has come from increases in real sales and increases in population.
- Second, consumers and businesses have benefited greatly from paying below-average relative prices (compared to overall consumer price increases) for the taxable commodities they purchased. These relatively small price increases on taxable sales have contributed to higher per capita incomes, which increased approximately 46 percent from 1993 to 2002.

**Figure 15**



## APPENDIX A: SSTIS STATE LEGISLATIVE STATUS

<b>SSTIS State Participation Status:</b> <i>States listed in bold italics are compliance with the SSTIS and have passed legislation to conform to the SSUTA.</i>			
<b>State</b>	<b>Population</b>	<b>Legislation</b>	<b>Status</b>
Alabama	4,447,100	HB 694	
Alaska		HB 293	Legislation establishes a state sales tax and brings state into compliance.
Arizona	5,130,632		
<b><i>Arkansas</i></b>	<b><i>2,673,400</i></b>	<b><i>SB 483</i></b>	<b><i>Signed 4/11/03</i></b>
California	33,871,648	SB 157	Became member. Effective 1/1/04. Observer Status on 3/26/03.
Colorado	4,301,261		
Connecticut	3,405,565	SB 328	Endorses SSTIS Agreement.
Delaware			No Sales Tax.
District of Columbia		The City Council passed a resolution in 2002 to bring the majority of the city's sales tax statutes into SSTIS compliance.	
Florida	15,982,378	SB 56, HB 607	Compliance. Effective 1-1-06
Georgia	8,186,453	HB 1437	Observer Status; Became member.
Hawaii	1,211,537	HB 1226, SB 1397	Became member effective 7-1-03
Idaho	1,293,953	S 1193	Enter into SSTP Agreement.
Illinois	12,419,293	SB 631, HB 848 to 851	Will bring state into compliance.
<b><i>Indiana</i></b>	<b><i>6,080,485</i></b>	<b><i>SB 465, HB 1815</i></b>	<b><i>Conform. Effective 1/1/04.</i></b>
<b><i>Iowa</i></b>	<b><i>2,926,324</i></b>	<b><i>SB 1200</i></b>	<b><i>Compliance. Effective 7/1/04.</i></b>
<b><i>Kansas</i></b>	<b><i>2,688,418</i></b>	<b><i>HB 2005</i></b>	<b><i>Compliance. Effective 7/1/03 &amp; 1/1/05.</i></b>
<b><i>Kentucky</i></b>	<b><i>4,041,769</i></b>	<b><i>HB 293</i></b>	<b><i>Conform. Effective 7/1/04.</i></b>
Louisiana	4,468,976	SB 551, SB 674, SB 708, SB 719	Partial compliance with STTP.
Maine	1,274,923	HB 552	Would bring state into compliance.
Maryland	5,296,486	HB 694	Signed 5/25/04. Compliance pending action by Congress to grant collection authority.
Massachusetts	6,349,097	SB 1949	Became a member of SSTP. Approved 3/5/03.
<b><i>Michigan</i></b>	<b><i>9,938,444</i></b>	<b><i>HB 5502, 5503, 5504, 5505</i></b>	<b><i>Compliance. Effective 9/1/04</i></b>
<b><i>Minnesota</i></b>	<b><i>4,919,479</i></b>	<b><i>SF1007, SF1008, HR1463, HF1597, SF1505</i></b>	<b><i>Compliance. Effective 1/1/04.</i></b>
Mississippi	2,844,658	SB 2089	Signed 3/8/03. Became SSTP member.
Missouri	5,595,211	SB 830	Would bring state into compliance. Effective 8/28/04.
Montana		SB 470	No Sales Tax. Enact a 4% sales tax, become a member of SSTP.

### Appendix A: SSTIS State Participation Status (continued)

State	Population	Legislation	Status
<i>Nebraska</i>	<i>1,711,263</i>	<i>LB 282</i>	<i>Compliance. Effective 1/1/04.</i>
<i>Nevada</i>	<i>1,998,257</i>	<i>AB 514</i>	<i>Compliance. Effective 7/1/03.</i>
New Hampshire			No Sales Tax.
New Jersey	8,414,350	S 1958, A 3473	Would bring state into compliance. Effective date depends on date of enactment. Not before 7/1/05.
New Mexico	1,819,046	HB 891	Legislation conforms local sales taxes to SSTIS Agreement.
New York	18,976,457	S 1406-BIA.2106-B (Budget) Laws of 2003	Legislation made the state a member of the SSTIS. 5/15/03
<i>North Carolina</i>	<i>8,049,313</i>	<i>SB 99, HB 44, HB 397</i>	<i>Compliance. HB 397 signed 6/30/03.</i>
<i>North Dakota</i>	<i>642,200</i>	<i>SB 2095, SB 2096</i>	<i>Compliance. Effective 12/31/05.</i>
<i>Ohio</i>	<i>11,353,140</i>	<i>HB 95</i>	<i>Compliance. Effective 1/1/05.</i>
<i>Oklahoma</i>	<i>3,450,654</i>	<i>HB 1712, SB 708</i>	<i>Compliance. Effective 11/1/03.</i>
Oregon		HB 3500, HB 3608	No Sales Tax. Enact a sales tax and become a member of SSTP.
Pennsylvania	12,281,054		
Rhode Island	1,048,319		
South Carolina	4,012,012		
<i>South Dakota</i>	<i>754,844</i>	<i>SB 76</i>	<i>Compliance. Effective 1/1/04.</i>
<i>Tennessee</i>	<i>5,689,283</i>	<i>SB 899, HB 823</i>	<i>Compliance. Signed 6/16/03.</i>
<i>Texas*</i>	<i>20,851,820</i>	<i>SB 823, HB 3143</i>	<i>Compliance with SSTIS Agreement. Effective 10/1/03 and 7/1/04.</i>
<i>Utah</i>	<i>2,233,169</i>	<i>SB 147</i>	<i>Compliance. Effective 1/1/04. Implementation delayed ?</i>
<i>Vermont</i>	<i>608,827</i>	<i>HB 480</i>	<i>Compliance. Signed 6/18/03.</i>
Virginia	7,078,515	SJR 347, HJR 657	Create a study committee to review the impact of the SSTP Agreement.
<i>Washington*</i>	<i>5,894,121</i>	<i>SB 5783, HB 1863, HB 2500, SB 6544, HB 2501, SB 6515</i>	<i>Conform majority of statutes to SSTP Agreement. Sourcing and Definition of Food are problems.</i>
<i>West Virginia</i>	<i>1,808,344</i>	<i>HB 3014</i>	<i>Conform. Effective 1/1/04.</i>
Wisconsin	5,363,675	AB 100 (2/9/05)	Would bring state into compliance. 10/1/05
<i>Wyoming</i>	<i>496,782</i>		<i>Compliance. Enacted legislation 2002.</i>
Total Population, states with sales tax:		273,882,935	
Population required to implement:		54,776,587	
<b>Population of 19 States in the</b>			
<b>Conforming States Committee, SSTIS:</b>		<b>72,064,395</b>	<i>As of 2/15/2005</i>
Source: <a href="http://www.streamlinedsalestax.org/statestatus.pdf">http://www.streamlinedsalestax.org/statestatus.pdf</a> as of February 15, 2005.			
* <i>Texas and Washington are in partial compliance. They are not on the Conforming States Committee.</i>			

## APPENDIX B: SSUTA SECTIONS

<b>Article I – Purpose and Principle</b>	<b>Article III – Continued</b>
101 Title	325 Customer Refund Procedures
102 Fundamental Purpose	326 Direct Payment
103 Taxing Authority Preserved	327 Library of Definitions
104 Defined Terms	328 Taxability Matrix
105 Treatment of Vending Machines	329 Effect of Date for Rate Changes
<b>Article II - Definitions</b>	<b>Article IV - Seller Registration</b>
201 Agent	401 Seller Participation
202 Certified Automated System (CAS)	402 Amnesty for Registration
203 Certified Service Provider (CSP)	403 Method of Remittance
204 Entity-Based Exemption	404 Registration by a Agent
205 Model 1 Seller	<b>Article V - Provider and System Certification</b>
206 Model 2 Seller	501 Certification of Service Providers & Automated Systems
207 Model 3 Seller	<b>Article VI – Monetary Allowances for New Technological</b>
208 Person	<b>Modes for Sales Tax Collection</b>
209 Product-Based Exemption	601 Monetary Allowance Under Model 1
210 Purchaser	602 Monetary Allowance Under Model 2
211 Registered Under the Agreement	603 Monetary Allowance Under Model 3 & all other sellers not under Models 1,2
212 Seller	<b>Article VII – Agreement Organization</b>
213 State	701 Effective Date
214 Use-Based Exemption	702 Approval of Initial States Prior to the Effective date of Agreement
<b>Article III – Requirements Each State Must Accept to Participate</b>	<b>Article VIII – State Entry and Withdrawal</b>
301 State Level Administration	801 Entry Into Agreement after Effective Date
302 State and Local Tax Bases	802 Certificate of Compliance
303 Sellers Registration	803 Annual Re-Certification of Member States
304 Notice For State Tax Changes	804 Requirements for Membership Approval
305 Local Rate & Boundary Changes	805 Compliance
306 Relief From Certain Liability	806 Agreement Administration
307 Database Requirement & Expectation	807 Open Meetings
308 State and Local Rates	808 Withdrawal of Membership or Expulsion of a Member
309 Application of General Sourcing Rules & Exclusions from the Rule	809 Sanction of Member States
310 General Sourcing Rules	810 State & Local Advisory Council
311 General Sourcing Definitions	811 Business & Taxpayer Advisory Council
312 Multiple Points of Use (MPU)	<b>Article IX – Amendments and Interpretations</b>
313 Direct Mail Sourcing	901 Amendments to Agreement
314 Telecommunication Sourcing Rules	901 Interpretation of Agreement
315 Telecommunication Sourcing Definitions	903 Definition Requests
316 Enactment of Exemption	<b>Article X – Issue Resolution Process</b>
317 Administrative Exemptions	1001 Rules & Procedures for Issue Resolution
318 Uniform Tax Returns	1002 Petition for Resolution
319 Uniform Rules for Remittances Funds	1003 Final Decision of Governing Board
320 Uniform Rules for Recovery of Bad Debts	1004 Limited Scope of This Article
321 Confidentiality & Privacy Protections Under Model 1	<b>Article XI – Relationship of Agreement to Member States and Persons</b>
322 Sales Tax Holidays	1101 Cooperating Sovereigns
323 Caps & Thresholds	1102 Relationship to State Law
324 Rounding Rule	1103 Limited Binding & Beneficial Effects
	1104 Final Determinations
	<b>Article XII – Review of Costs and Benefits</b>
	1201 Review of Costs & Benefits

## APPENDIX C: CALIFORNIA TAX CODE SECTIONS AND REGULATIONS PERTAINING TO GENERAL SOURCING

California Revenue and Taxation Code Sections and Regulations that Relate to General Sourcing (Sections 309, 310, and 311 of the SSUTA)	
Section	
6006	Sale
6006.3	Lease
6009.1	Storage and use - exclusion
6010	Purchase
6010.5	Place of sale
6010.7	Sale and purchase – chemical toilet
6011	Sales price
6012	Gross receipts
6012.6	Factory-built school building
6012.7	Factory-built housing
6012.8	Mobile homes-installed as residences
6012.9	Mobile homes-installed as residences subject to property tax
6016.3	Leased fixtures
6022	Vehicle; motor vehicle
6023	Mobile transportation equipment
6024	One-way rental trucks
6077	Retail florists
6092.1	Lessors of mobile transportation equipment
6094.1	Leases; election to pay use tax
6203	Collection by retailer
6244.5	Leases of qualifying manufacturing property; cost price
6272	Vehicle
6273	Vessel
6274	Aircraft
6366.1	Aircraft leased to common carriers, foreign governments, and nonresidents
6368	Watercraft
6368.1	Watercraft leased for use in interstate or foreign commerce or for commercial fishing
6390	Rentals included in use tax or outside state
6391	Prior leases
6407	Prior leases
7204.03	Place of sale; sales of jet fuel
7205	Place of sale
7205.1	Place of sale; leases of motor vehicles
7261	Required provisions of the transactions tax
7262	Required provisions of the use tax
7263	Place of sale
Regulation	
1502	Computer, programs, and data processing
1521.4	Factory-built housing
1571	Florists
1593	Aircraft and aircraft parts
1594	Watercraft
1610	Vehicles, vessels, and aircraft
1610.2	Mobile homes and commercial coaches
1628	Transportation charges
1660	Leases of tangible personal property – in general
1661	Leases of mobile transportation equipment
1669	Demonstration, display and use of property held for resale - general

<b>Appendix C (continued): California Revenue and Taxation Code Sections and Regulations that Relate to General Sourcing</b>	
Regulation	
1686	Receipts for tax paid to retailers
1802	Place of sale and use for purposes of Bradley-Burns uniform local sales and use taxes
1803	Application of tax
1803.5	Long-term leases of motor vehicles
1805	Aircraft common carriers
1806	Construction contractors
1822	Place of sale for purposes of transactions (sales) and use taxes
1823	Application of transactions (sales) tax and use tax
1823.5	Place of delivery of certain vehicles, aircraft and undocumented vessels
1825	Aircraft common carriers
1826	Construction contractors
Source: California State Board of Equalization. <i>Streamlined Sales Tax Project: A Report to the Legislation on the Streamlined Sales Tax Project</i> . September 23, 2004. <a href="http://www.boe.ca.gov/pdf/2Q04SSTPLegislativeReportForApproval.pdf">http://www.boe.ca.gov/pdf/2Q04SSTPLegislativeReportForApproval.pdf</a> .	

## APPENDIX D: WASHINGTON SOURCING STUDY METHODOLOGY AND MITIGATION PRINCIPLES

The Washington Department of Revenue (DOR) conducted a study in 2003 of the fiscal impact on local jurisdictions that would result from adopting the sourcing provisions proposed in the SSUTA. DOR also consulted a committee composed of city and county officials to assist with the study. Various mitigation options for jurisdictions negatively impacted by the SSUTA were included in the study. In September 2004, improvements to the 2003 estimates were issued.

**Methodology:** To calculate the sourcing estimates, DOR measured the dollar amount of delivered sales attributable to Washington State, determined where the sales originated and where the sales were delivered. For each jurisdiction, gains and losses were estimated for both remote sales and in-store sales. The analysis was performed using existing data from the Departments of Revenue and Employment Security and data from a survey conducted by the Washington State University Social and Economic Sciences Research Center. All data are on the firm level for Washington businesses potentially affected by sourcing changes (businesses that make taxable retail sales and deliver products within the state). The Departments of Revenue and Employment Security data included taxable retail sales by establishment, business location for each establishment, and business classification.

The survey sample included approximately 2,400 businesses and was stratified by size and by industry classifications, including manufacturing, printing, transportation and warehousing, wholesale, furniture retailing, electronics and appliances retailing, office supplies retailing, and other retailers. Businesses were asked questions in the survey about the percentage of sales made: remotely; from storefronts; from storefronts, but delivered from a warehouse;\* to businesses; to households; to each county. Businesses were also asked to break out their store-based delivered retail sales:

- Within the city where the store is located.
- Within the radius of miles (5, 10, etc.) of the store location.
- Within the rest of the county.
- Within the rest of the state.

Approximately 1,200 businesses responded to the survey. Survey responses were matched by Washington State University to data provided by the Departments of Revenue and Employment Security. Survey data were used to calculate average answers for each question for each industry classification. The appropriate averages were applied to each firm that was sampled. The final database included each establishment of each Washington firm that would potentially be affected by sourcing.

The net fiscal impact for each jurisdiction included both gains and losses. The total value of outgoing sales and deliveries, which represent a loss to each jurisdiction, was calculated using the survey responses combined with the departments' data. Gains were

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\* Washington is unique in sourcing delivered goods to the retail outlet from which delivery took place.

derived from the estimated total value of incoming deliveries allocated to each jurisdiction using survey data, Department data on business purchasing activity, and household income data. Geographic Information System was used to map locations of each storefront and warehouse, and then to allocate gains to each jurisdiction based on survey data and census block level household income data.

The survey data were intended to represent taxpayers by industry and location, but were less precise when used to estimate smaller jurisdictional gains. The larger cities are generally more likely to have firms that conform to industry averages and are also better represented in the data because more firms responded to the survey. The results of the survey calculations are estimates that contain a margin of error and are intended to provide general information on jurisdictional losses and gains.

***Mitigation Principles:*** Options were developed to mitigate the effects of SSUTA sourcing using the four following principles:

1. The committee supports the general objectives of the SSUTA
2. Mitigation must be based on actual experience rather than projections.
3. Mitigation must be funded by the state.
4. Any mitigation method must address losses by all types of jurisdictions affected, including counties, cities, transit, and special purpose districts.

Once the effects of SSUTA sourcing are known, mitigation options will be reexamined. Depending on the retailing activity in the jurisdiction, new revenues from remote sellers may partially or totally mitigate the effects of SSUTA sourcing. Since no option received unanimous support of the committee, the report presented seven options:

1. Option 1: City of Seattle
2. Option 2: Washington State Association of Counties (WSAC)
3. Option 3: City of Kent
4. Option 4: City of Kent - Simplified
5. Option 5: Department of Revenue (DOR)
6. Option 6: City of Redmond
7. Option 7: City of Puyallup

Options 1 and 2 (Seattle and WSAC) use state revenue to mitigate the effects of SSUTA sourcing. Options 3, 4 and 5 (both Kent options and DOR) mitigate SSUTA sourcing by returning revenues sourced to the point of delivery to the point of origin. Option 6 (Redmond) would temporarily pool local sales taxes and distribute them based upon the proportion each jurisdiction or agency currently receives during a pre-selected period. Option 7 (Puyallup) delays SSUTA sourcing until Congress or the Supreme Court acts to require remote sellers to collect and remit sales and use taxes to the states. Legal concerns were raised with respect to Options 3, 4, 5 and 6, which redistribute sales tax from one local jurisdiction to another local jurisdiction. Another mitigation option offered by the advisory committee, sourcing intrastate and interstate sales differently, was thought to be in potential violation of the Commerce Clause of the U.S. Constitution.

## APPENDIX E: STATE SALES TAX RATES, EXEMPTIONS

### STATE SALES TAX RATES AND EXEMPTIONS

1-Jan-04

State	State Tax Rate (%)	-----Exemptions-----		
		Food	Prescription Drugs	Non-prescription Drugs
ALABAMA	4		e	
ALASKA	none			
ARIZONA	5.6	e	e	
ARKANSAS	5.125		e	
CALIFORNIA (3)	7.25 (2)	e	e	
COLORADO	2.9	e	e	
CONNECTICUT	6	e	e	e
DELAWARE	none			
FLORIDA	6	e	e	e
GEORGIA	4	e	e	
HAWAII	4		e	
IDAHO	6		e	
ILLINOIS (2)	6.25	1%	1%	1%
INDIANA	6	e	e	
IOWA	5	e	e	
KANSAS (6)	5.3		e	
KENTUCKY	6	e	e	
LOUISIANA	4	e (4)	e	
MAINE	5	e	e	
MARYLAND	5	e	e	e
MASSACHUSETTS	5	e	e	
MICHIGAN	6	e	e	
MINNESOTA	6.5	e	e	e
MISSISSIPPI	7		e	
MISSOURI	4.225	1.225	e	
MONTANA	none			
NEBRASKA (7)	5.5	e	e	
NEVADA	6.5	e	e	
NEW HAMPSHIRE	none			
NEW JERSEY	6	e	e	e
NEW MEXICO	5		e	
NEW YORK	4.25	e	e	e
NORTH CAROLINA	4.5	e (4)	e	
NORTH DAKOTA	5	e	e	
OHIO	6	e	e	
OKLAHOMA	4.5		e	
OREGON	none			
PENNSYLVANIA	6	e	e	e

**Appendix E: State Sales Tax Rates and Exemptions (continued)**  
**1-Jan-04**

State	State Tax Rate (%)	-----Exemptions-----		
		Food	Prescription Drugs	Non-prescription Drugs
RHODE ISLAND	7	e	e	e
SOUTH CAROLINA	5		e	
SOUTH DAKOTA	4		e	
TENNESSEE	7	6%	e	
TEXAS	6.25	e	e	e
UTAH	4.75		e	
VERMONT	6	e	e	e
VIRGINIA	4.5 (2)	4% (5)	e	e
WASHINGTON	6.5	e	e	
WEST VIRGINIA	6		e	
WISCONSIN	5	e	e	
WYOMING (3)	4		e	
DIST. OF COLUMBIA	5.75	e	e	e

Source: Federation of Tax Administrators, <http://www.taxadmin.org/fta/rate/sales.html>

e: Indicates exempt from tax, blank indicates subject to general sales tax rate.

- (1) Some states tax food, but allow an (income) tax credit to compensate poor households. They are: HI, ID, KS, SD and WY.
- (2) Includes statewide local tax of 1.25 percent in California and 1.0 percent in Virginia
- (3) Tax rate may be adjusted annually according to a formula based on balances in the unappropriated general fund and the school foundation fund.
- (4) Food sales are subject to local sales taxes. In LA, food sales scheduled to be exempt on 7/1/03.
- (5) Tax rate on food is scheduled to decrease to 3.5 percent on 4/1/03. Statewide local tax of one percent is not included.

## APPENDIX F: STATE SALES TAX RATES, VENDOR COMPENSATION

STATE SALES TAX RATES AND VENDOR DISCOUNTS				
(January 1, 2004)				
STATE	STATE SALES TAX RATE (%)	RANK	VENDOR DISCOUNT As % of tax paid	MAX/MIN
ALABAMA	4	39	5.0%-2.0% (1)	
ALASKA	-----	-----N/A-----	-----	
ARIZONA	5.6	20	1%	\$10,000/year (max)
ARKANSAS	5.125	25	2%	\$1,000/month (max)
CALIFORNIA (3)	6	9	None	
COLORADO	2.9	46	2.33% (4)	
CONNECTICUT	6	9	None	
DELAWARE	-----	-----N/A-----	-----	
FLORIDA	6	9	2.5%	\$30/report (max)
GEORGIA	4	39	3%-0.5% (1)	
HAWAII	4	39	None	
IDAHO	6	9	None (5)	
ILLINOIS	6.25	7	1.75%	\$5/year (min)
INDIANA (2)	6	9	0.83%	
IOWA	5	26	None	
KANSAS (9)	5.3	24	None	
KENTUCKY	6	9	1.75%-1.0% (1)	
LOUISIANA	4	39	1.1%	
MAINE	5	26	None (5)	
MARYLAND	5	26	0.6%-0.45% (1)	
MASSACHUSETTS	5	26	None	
MICHIGAN	6	9	0.5% (6)	\$6/month (min)
MINNESOTA	6.5	4	None	
MISSISSIPPI	7	1	2%	\$50/month (max)
MISSOURI	4.225	37	2%	
MONTANA	-----	-----N/A-----	-----	
NEBRASKA (10)	5.5	23	2.5%	\$75/month (max)
NEVADA	6.5	4	0.5%	
NEW HAMPSHIRE	-----	-----N/A-----	-----	
NEW JERSEY	6	9	None	
NEW MEXICO	5	26	None	
NEW YORK	4.25	37	3.5%	\$150/quarter (max)
NORTH CAROLINA	4.5	35	None	
NORTH DAKOTA	5	26	1.5%	\$255/quarter (max)
OHIO	6	9	0.9%	
OKLAHOMA	4.5	35	2.25%	\$3,000/month (max)
OREGON	-----	-----N/A-----	-----	
PENNSYLVANIA	6	9	1%	
RHODE ISLAND	7	1	None	

<b>Appendix F: STATE SALES TAX RATES AND VENDOR DISCOUNTS (continued)</b>				
<b>(January 1, 2004)</b>				
<b>STATE</b>	<b>STATE SALES</b>		<b>VENDOR DISCOUNT</b>	
	<b>TAX RATE (%)</b>	<b>RANK</b>	<b>As % of tax paid</b>	<b>MAX/MIN</b>
SOUTH CAROLINA	5	26	3%-2% (1)	\$3,000/year (max)
SOUTH DAKOTA	4	39	None	
TENNESSEE	7	1	None	
TEXAS	6	7	0.5% (7)	
UTAH	4.75	34	1.5%	
VERMONT	6	9	None (5)	
VIRGINIA (3)	3.5	45	4%-2% (8)	
WASHINGTON	6.5	4	None	
WEST VIRGINIA	6	9	None	
WISCONSIN	5	26	0.5%	\$10/period (min)
WYOMING	4	39	None	
DIST. OF COLUMBIA	5.75	21	1%	\$5,000/month (max)
U. S. MEDIAN	5.5		1.9%-1.5% (1)	27 states allow vendor discounts
Source: Federation of Tax Administrators, <a href="http://www.taxadmin.org/fta/rate/sale_vdr.html">http://www.taxadmin.org/fta/rate/sale_vdr.html</a>				

- (1) In some states, the vendors' discount varies by the amount paid. In AL and SC, the larger discounts apply to the first \$100. In GA, the larger discount applies to the first \$3,000. In KY, the larger discounts apply to the first \$1,000, while MD applies the larger discount to annual collections of \$6,000. The lower discounts apply to the remaining collections above these amounts.
- (2) Utilities are not permitted to take discount.
- (3) Rate does not include a statewide local rate of 1.25 percent in CA and 1.0 percent in VA.
- (4) Vendor discount applies to the state taxes collected. Discount for local option sales tax varies from 0 percent to 3.33 percent.
- (5) Vendors are allowed to keep any excess collections prescribed under the bracket system.
- (6) Vendor discount only applies to the first 4.0 percent of the tax.
- (7) An additional discount of 1.25 percent applies for early payment.
- (8) Discount varies; four percent of the first \$62,500, three percent of the amount to \$208,000, and two percent of the remainder.
- (9) Vendor discount rate will increase to 1.2 percent and 0.9 percent on 7/1/04.

## APPENDIX G: TAXABILITY MATRIX

Approved by the Streamlined Sales Tax Project at its January 13, 2004 meeting.\*

This document is intended to gather information about member states' treatment of the terms in the Streamlined Sales and Use Tax Agreement's (SSUTA) Library of Definitions.

The information in the Taxability Matrix is required by Section 328 of the SSUTA approved November 12, 2002, to ensure uniform application of terms in the Library of Definitions within the Agreement. Sellers and certified service providers will be relieved from tax liability to member states and their local jurisdictions for having charged and collected the incorrect amount of sales and use tax resulting from the seller or certified service provider relying on erroneous data provided by the member state relative to terms defined in the Library of Definitions.

### *SSTP Taxability Matrix Form:*

Please complete the document according to the instructions. Attach the Taxability Matrix to your state's Certificate of Compliance and submit it to the Governing Board when your state petitions to be certified as compliant with the provisions of the SSUTA.

State:

Completed by:

E-mail address:

Phone number:

Each of the items listed in the chart are defined in the Library of Definitions in the Streamlined Sales Tax Agreement adopted November 12, 2002, or adopted by the Implementing States subsequent to November 12, 2002. Refer to Appendix C of the Streamlined Sales Tax Agreement for each definition. Complete each line to indicate the treatment of each definition in your state. If the definition does not apply, or if there is no statute cite in your state, enter "NA" in the space provided. **Sellers and certified service providers are relieved from tax liability to the member state and its local jurisdictions for having charged and collected the incorrect amount of sales or use tax resulting from the seller or certified service provider relying on erroneous data provided by the member state relative to treatment of the terms defined in the Library of Definitions.**

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\* The taxability matrix is available at: <http://www.streamlinedsalestax.org/Taxability%20matrixFinal1.pdf>.

<b>Appendix G: Taxability Matrix - Administrative Definitions</b>			
	<b>Taxable</b>	<b>Exempt</b>	<b>Statute/Rule Cite</b>
<b>Delivery charges</b> including direct mail			
<b>Delivery charges</b> excluding direct mail			
<b>Direct mail</b>			
<b>Sales price</b> (identify how the options listed below are treated in your state)	<b>Included in sales price</b>	<b>Excluded from sales price</b>	<b>Statute/Rule Cite</b>
*Services necessary to complete the sale other than delivery and installation			
*Delivery charges including direct mail			
*Delivery charges excluding direct mail			
*Installation charges			
*Exempt personal property bundled with taxable personal property			
*Credit for trade-in			
<b>Taxability Matrix - Product Definitions</b>			
	<b>Taxable</b>	<b>Exempt</b>	<b>Statute/Rule Cite</b>
<b>Clothing and related products</b>			
Clothing			
Clothing accessories or equipment			
Protective equipment			
Sport or recreational equipment			
<b>Computer related products</b>			
Computer software (not prewritten)			
Computer software (not prewritten) delivered electronically			
Computer software (not prewritten) delivered via load and leave			
Prewritten computer software			
Prewritten computer software delivered electronically			
Prewritten computer software delivered via load and leave			
<b>Food and food products</b>			
Candy			
Dietary supplements			
Food and food ingredients			
Food sold through vending machines			
Soft drinks			
<b>Prepared food</b>			
Prepared food options – indicate whether the following options are included or excluded from the definition of prepared food.			
*Food sold without eating utensils provided by the seller whose primary NAICS classification is manufacturing in sector 311, except subsector 3118 (bakeries)			
*Food sold without eating utensils provided by the seller in an unheated state by weight or by volume as a single item			
*Bakery items sold without eating utensils provided by the seller, including bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, Danish, cakes, tortes, pies, tarts, muffins, bars, cookies tortillas			

<b>Appendix G: Taxability Matrix - Administrative Definitions (continued)</b>			
<b>Health-Care</b>			
<b>Drugs</b> (indicate how the options are treated in your state)	<b>Taxable</b>	<b>Exempt</b>	<b>Statute/Rule Cite</b>
*Drugs for human use without a prescription			
*Drugs for human use with a prescription			
*Drugs for animal use without a prescription			
*Drugs for animal use with a prescription			
*Insulin without a prescription			
*Insulin with a prescription			
*Medical oxygen without a prescription			
*Medical oxygen with a prescription			
*Over-the-counter drugs without a prescription			
*Over-the-counter drugs with a prescription			
*Grooming and hygiene products			
*Drugs and prescription drugs to hospitals and other medical facilities			
*Taxable and nontaxable drugs bundled together			
*Free samples of drugs			
<b>Durable medical equipment</b> (indicate how the options are treated in your state)	<b>Taxable</b>	<b>Exempt</b>	<b>Statute/Rule Cite</b>
*Durable medical equipment without a prescription			
*Durable medical equipment with a prescription			
*Durable medical equipment paid for or reimbursed by Medicare			
*Durable medical equipment paid for or reimbursed by Medicaid			
*Durable medical equipment for home use without a prescription			
*Durable medical equipment for home use with a prescription			
*Durable medical equipment for home use paid for or reimbursed by Medicare			
*Durable medical equipment for home use paid for or reimbursed by Medicaid			
<b>Mobility enhancing equipment</b> (indicate how the options are treated in your state)			<b>Statute/Rule Cite</b>
*Mobility enhancing equipment without a prescription			
*Mobility enhancing equipment with a prescription			
*Mobility enhancing equipment paid for or reimbursed by Medicare			
*Mobility enhancing equipment paid for or reimbursed by Medicaid			
<b>Prosthetic devices</b> (indicate how the options are treated in your state)			<b>Statute/Rule Cite</b>
*Prosthetic devices without a prescription			
*Prosthetic device with a prescription			
*Corrective eyeglasses without a prescription			
*Corrective eyeglasses with a prescription			
*Corrective eyeglasses paid for or reimbursed by Medicare			
*Corrective eyeglasses paid for or reimbursed by Medicaid			
*Contact lenses without a prescription			
*Contact lenses with a prescription			
*Contact lenses paid for or reimbursed by Medicare			
*Contact lenses paid for or reimbursed by Medicaid			
*Hearing aids without a prescription			
*Hearing aids with a prescription			
*Hearing aids paid for or reimbursed by Medicare			
*Hearing aids paid for or reimbursed by Medicaid			
*Dental prosthesis without a prescription			
*Dental prosthesis with a prescription			
*Dental prosthesis paid for or reimbursed by Medicare			
*Dental prosthesis paid for or reimbursed by Medicaid			

## APPENDIX H: CALIFORNIA LEGISLATION SUMMARY

**\*Bold indicates the bill was enacted.**

### *2003-2004 Regular Session*

<b>SB 103</b>	<b>Alpert</b>	<b>Sales and Use Taxes/Corporation Tax Law*</b>
<b>SB 157</b>	<b>Bowen</b>	<b>Sales and Use Taxes, Uniformity; SSTP</b>
AB 128	Campbell	Internet Tax Freedom Act; continuation
<b>SB 1009</b>	<b>Alpert</b>	<b>Use tax collection: public contracts: income tax forms</b>
SB 1559	Bowen	Partially conforms to the SSUTA by allowing an agent for a seller or an agent for a retailer to obtain a seller's permit.

### *2001-2002 Regular Session*

SB 394	Sher	Internet Tax Freedom Act; continuation
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### *1999-2000 Regular Session*

AB 2412	Migden	Sales and use taxes: retailer
<b>AB 330</b>	<b>Floyd</b>	<b>Sales and use taxes: retailers and sellers: conventions and trade shows.</b>
SB 1949	Costa	Sales and use taxes: uniformity
AB1784	Lempert	Internet Tax Freedom Act; continuation
<b>SB 1933</b>	<b>Vasconcelles</b>	<b>Commission on Tax Policy in the New Economy</b>

### *1998-1999 Regular Session*

<b>AB 1614</b>	<b>Lempert</b>	<b>Sales and use tax: Internet Tax Freedom Act</b>
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### *1996-1997 Regular Session*

AJR 20	Lempert	Relative to taxation of Internet activity
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\* SB103 was introduced as a sales tax bill that would have clarified nexus rules in California. Its provisions were essentially the same as AB2412 (Migden). As enacted, SB 103 concerned corporate tax law.

## APPENDIX I: COMMISSION PRESENTATIONS ON THE SALES TAX

Presentations made to the Commission on Tax Policy in the New Economy on sales and use taxes are included in the Commission's *Proceedings*, December 2003. These documents are available online at:

<http://www.library.ca.gov/CaTax/index.cfm>.

Commission on Tax Policy in the New Economy Hearing Dates	
SSTP	Sales and Use Taxes
5/16/02	1/29/02
7/29/02	3/20/02
3/12/03	2/3/03
10/23/03	10/23/03

*January 29, 2002: Sacramento*

How the Internet Affects the Board of Equalization

*Honorable John Chiang - Chair, California Board of Equalization*

Tangible and Intangible Taxable Property

*Mike Brownell - Multi-state Technical Legal Coordinator, Franchise Tax Board*

The Shifting Tax Base from Tangible Goods to Services and E-Commerce and its Effect on State Revenues

*Alan Auerbach, Ph.D. - Chair, Department of Economics, UC Berkeley*

The Changing Economy in California and its Impact on Tax Revenues

*Terri Sexton, Ph.D. - Associate Director, Center for State and Local Taxation,  
UC Davis Chair, Department of Economics, CSU Sacramento*

The Dos and Don'ts of Tax Policy for the New Economy

The Nuttiness of State and Local Taxes – And the Nuttiness of Responses Thereto

*Charles McLure, Ph.D. - Senior Fellow, Hoover Institution, Stanford University*

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*March 20, 2002: Sunnyvale*

Characteristics of California's Tax System

*Mark Ibele, Ph.D. - California Legislative Analyst's Office*

Sales and Use Tax Considerations for Cities

*Mary Bradley - Director of Finance, City of Sunnyvale*

Sales Tax Challenges in the New Economy

*Robert Locke - Finance and Administrative Services Director, City of Mountain View*

Tax Policy, Trends and Issues

*Annette Nellen, CPA, Esq. - Professor, San Jose State University and Chair, Tax and Policy Group, Joint Venture: Silicon Valley Network*

R & D Tax Credits and Tax Simplification

*Terry Ryan - Director, State and Local Taxes, Apple Computer*

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*May 16, 2002: Santa Monica*

Streamlined Sales Tax Project (SSTP)

*Charles Collins - North Carolina Department of Revenue*

*Diane Hardt - Wisconsin Department of Revenue*

Streamlined Sales Tax Project (SSTP)

*Steven Kranz - Tax Counsel, Council on State Taxation (COST)*

Arguments against California Participating in the SSTP

*Dean Andal - Member, California Board of Equalization*

Critical Issues for California's Tax Structure

*Jean Ross - Executive Director, California Budget Project*

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*July 29, 2002: Bakersfield*

Streamlined Sales Tax Project (SSTP)

*Daniel Thompson - Certified Public Accountant, Thompson Tax Associates*

The New Economy's Challenge for True Tax Reform and the "Streamlined Sales Tax Project"

*Lee Goodman - Counsel, Wiley, Rein & Fielding*

Governor Davis' Veto of SSTP and Internet Sales Tax Legislation

*Connie Squires - Program Budget Manager, California Department of Finance*

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*February 3, 2003: Sacramento*

Revenues Expected from Various Sales Tax Rates on 25 Selected Services

Revenues Expected from Various Sales Tax Rates on 36 Selected Services

State Sales & Use Tax (SUT) Breakdown

Budget Revenue Enhancement Proposals, 2003 - 2004

*Honorable John Dutra - California State Assembly Member*

*Honorable Jackie Goldberg - California State Assembly Member*

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*March 12, 2003: Sacramento*

Streamlined Sales Tax Project

*Charles D. Collins Jr. - Director, Government Affairs, Taxware*

*Bruce Johnson - Co-Chair, Streamlined Sales Tax Project*

*Scott Peterson – Director, Business Tax Division, Department of Revenue, State of South Dakota*

SB157, Internet Sales Tax

*Honorable Debra Bowen - California State Senator*

Perspective on Use Taxes

*Betty Yee – California State Board of Equalization*

Reforming California's Tax System

*Elizabeth Hill - California Legislative Analyst*

Overview of Sales and Use Taxes

*Commissioner Bill Weintraub*

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*October 23, 2003: San Diego*

Board of Equalization Perspectives on Sales Tax Issues

*Steve Kamp - Senior Tax Counsel to BOE Chairwoman Carole Migden*

*Dave Hayes - Manager, BOE Research and Statistics Division*

Economic and Fiscal Impacts of Taxing Services

*Mark Ibele, Ph.D. - Principal Fiscal and Policy Analyst, California Legislative Analyst's Office*

SB 1009 Use Tax Collections

*Honorable Dede Alpert - California State Senator*

## APPENDIX J: COMMISSIONER ROSSMAN MEMO ON THE SSTP

Date: May 15, 2003

To: Members, California Commission on Tax Policy in the New Economy

From: Commissioner Glen L. Rossman

Subject: Sales Tax Policy and Electronic Commerce

The Commission has reached a critical point in its deliberations concerning recommendations about the future of the sales tax. One of the ideas put forth is whether or not to recommend that California become a signatory to the "Streamline Sales and Use Tax Agreement ("SSUTA")." For the reasons set forth below, I believe California's participation in the SSTP/SSUTA would not be advisable. There is a great deal of misinformation circulating about the SSTP, we should be cautious.

**There is no longer a simplification "project" per se, but an "agreement" that must be taken at face value.**

Up to this point, the Commission has been under the impression that there was an ongoing "Simplified Sales Tax Project" which was still in the discussion stage. On November 12, 2002 the SSTP adopted an agreement (the SSUTA), which sets the basic parameters under which the simplified system will operate (copy attached). The so-called "implementing states" are currently in the process of referring the SSUTA to their respective legislatures for adoption *and are required under the agreement to bring their own sales tax systems into compliance with the SSUTA*. The SSUTA will become effective when at least 10 states with 20 percent of the total population of all states imposing a sales tax have enacted the conforming legislation and are found to be in compliance with the requirements of the Agreement.

In short, while there will be future discussions about future issues, the starting point of any analysis of the decision to join the SSUTA is the terms of that agreement itself, and what changes it would require in California law, and the policy ramifications of those changes. The Board of Equalization has already opined that the SSUTA is not compatible with California law.

**The agreement can only be amended by a vote of three-fourths of the adopting states, with each state receiving one vote.**

At the outset, it should be noted that the SSUTA is unlikely to be changed to accommodate any problems California has implementing the SSUTA (see below). We can presume that the states that have signed the SSUTA are pleased with its provisions; is it unlikely that California will be able to muster the votes of  $\frac{3}{4}$ 's of the member states (each state receiving one vote) it would take to change the agreement. (SSUTA, sec. 901, p. 45).

**The SSUTA is not mandatory for remote sellers and would not require remote sellers to register with California.**

As currently structured, the SSUTA is voluntary only, and out-of-state sellers who do not have a substantial physical presence in California could not be compelled to register and collect California sales and use taxes. The SSUTA can only become mandatory through

an act of the United States Congress or a reversal of *Quill* by the United States Supreme Court. No one has been able to show me why Congress would take the political heat for voting for what will be perceived as a new tax on catalog and Internet sales, while state and local government would get to spend the money. Moreover, the Supreme Court made it clear in *Quill* that Congress, not the Court, was the appropriate forum to address the issue. It is unlikely that the Court will be interested in revisiting and reversing their prior position, and in any event, such litigation would take years. Thus, if proponents are basing their support on the belief that adoption of the SSUTA will immediately trigger massive amounts of new cash flowing into California's coffers, they will certainly be disappointed in the result.

**The SSUTA would apply to ALL sellers, both intrastate and interstate, whether located inside the State or not.**

The SSUTA requires signatory states to bring their *entire* sales and use tax systems into compliance with the SSUTA, not just provisions affecting remote sellers. In other words, evaluation of the SSUTA needs to be in terms of its impact on *all* California retailers (Streamlined Sales Tax Project "Executive Summary" p. 2-Attached). Aspects of the SSUTA would require substantial changes in the California Sales and Use Tax Law. an outcome acknowledged by the SSUTA ("Other states with more complicated sales tax laws may require significant changes to current law to be in accord with the Agreement." Streamlined Sales Tax Project "Executive Summary" p. 3.).

The Board of Equalization presented detailed testimony identifying the problems presented by the SSUTA for domestic California retailers.

**The SSUTA would cause a substantial redistribution of sales and use tax revenue amongst California cities and counties.**

The California Bradley-Burns Uniform Local Sales and Use Tax system is built largely on a "place of sale" system. Sales and Use Tax Regulation 1802 holds that if a retailer has only one place of business in California, all retail sales occur at that place of business. If the retailer has more than one place of business, the place of the sale is "where the principal negotiations are carried on." For the California retailer with only one place of business, this means they only have to know one tax rate (where they are located) and they do not have to distribute those sales amongst multiple jurisdictions on their return. Moreover, the distribution of local sales taxes follows this system of where the sale takes place.

By contrast, the SSUTA is based on a "destination" basis (where the customer is located). This has two significant effects on California. First, all California retailers would have to track sales where the property was delivered to a customer in another jurisdiction, ascertain the sales tax jurisdiction, and allocation the sales (and the local tax) to the customer's jurisdiction. This creates a major new compliance burden for California retailers where none exists today, and disrupts the settled revenue expectations of California local jurisdictions.

**The SSUTA requires that the state pay retailers to administer sales and use taxes.**

Many states already give their retailers an allowance for administering their sales and use taxes. California does not. The SSUTA (sections 601-603) requires member states to

pay an undisclosed monetary allowance to vendors who voluntarily register to collect and remit sales tax in the state.

It might be politically difficult for California to pay retailers in other states to administer sales and use taxes for California without granting a similar allowance to its own domestic retailers. California has close to one million active sales tax accounts. One can do the math to see what an expense to California this provision may lead to.

### **The SSUTA is far from the goal of uniform definitions for all types of products.**

The SSUTA is being billed as a “comprehensive agreement.” It isn’t. The uniform definitions in the agreement cover only clothing (which is currently completely taxable in California), protective equipment, sports or recreational equipment, some software, food (which is constitutionally exempt from tax in California, except where served as a meal by a restaurant or caterer) and medicines. This is far from a comprehensive list of products sold through remote sales. The Board presented testimony that the SSUTA definitions of “prescription medicines” does not conform to California’s definition, and would require California to tax certain medicines currently exempt.

Once a uniform definition is agreed upon, the states remain free to tax or exempt that product. The agreement specifically states that a member state may enact a product-based exemption without restriction if the Agreement does not have a definition for the product or for a term that includes the product. (SSUTA, sec. 316(A)). A similar provision exists for exemptions that are entity-based or use-based. (SSUTA, sec. 316(B)). Thus, the lack of a complete inventory of uniform definitions will make it necessary for remote sellers to track exemptions on a 50-state basis at least.

### **There is no “one rate per state” requirement in the SSUTA.**

One of the most basic requirements of a simplified sales tax system is one tax rate per state. The SSUTA falls far short of that. Instead, the SSUTA allows multiple rates in two different respects: it allows differential rates for food and drugs (sec. 308(A)); second, it allows an additional local rate “per local jurisdiction” (sec. 308(B)). States would be required to maintain a database of local tax rates by five- and nine-digit zip code. (Sec. 305(E) and (F)). Local jurisdictions’ tax rate areas would be required to coincide with zip code boundaries. The SSUTA does not eliminate the problem of multiple tax rates for smaller, less sophisticated sellers.

### **Conclusion**

Multistate sales and use tax simplification is a good thing, and the participant states in the SSTP should be commended for their efforts at simplification. Many of the goals they seek, such as a uniform state and local sales tax base and state administration of the sales and use tax system have been in place in California for decades. But their efforts fall far short of addressing the real problems of tax compliance for remote sellers. Moreover, the program is voluntary for remote sellers, and would only be a small dent in the problem unless Congress steps in to legislate a solution (which it has not done in 40 years since *National Bellas Hess*), or a successful Supreme Court challenge to *Quill* (equally unlikely). Moreover, there would be problems created by California having to modify its current system and Constitution to meet the requirements of the SSUTA. Finally, with California the home of more pure Internet sellers than other states, our participation in the

SSTA would inure to the benefit of consumer states like North Dakota, and not to our own benefit. In sum, the SSUTA does not seem like the right path for our state.

From my perspective, California and the other states have not done enough to try and collect the use tax from its own citizens and its own businesses. There are common sense suggestions being formulated now that can be unilaterally implemented by California in a short period of time, are undisputedly legal, and would result in the bulk of use tax on remote sales being collected and remitted to the Board of Equalization for distribution to state and local government.

I believe we should recommend changes to California law that may substantially address the problem, before we support the imposition of a new, perhaps stifling compliance burden that will be litigated for years, not result in any immediate revenue for California and will disproportionately fall on California-based businesses.

## APPENDIX K: ADJUSTED SALES TAX DATA FOR 45 STATES

### 2003 Adjusted General State Sales & Gross Receipts Tax Collections (\$ Millions)

1 ALABAMA*	AL	1,894	23 MISSOURI	MO	2,819
2 ARIZONA*	AZ	4,287	24 NEBRASKA*	NE	1,420
3 ARKANSAS	AR	1,951	25 NEVADA	NV	2,192
4 CALIFORNIA	CA	24,899	26 NEW JERSEY	NJ	5,936
5 COLORADO	CO	1,833	27 NEW MEXICO*	NM	1,491
6 CONNECTICUT	CT	3,065	28 NEW YORK*	NY	8,507
7 FLORIDA*	FL	15,078	29 NORTH CAROLINA*	NC	3,992
8 GEORGIA*	GA	4,738	30 NORTH DAKOTA*	ND	429
9 HAWAII*	HI	1,707	31 OHIO	OH	6,761
10 IDAHO	ID	842	32 OKLAHOMA*	OK	1,503
11 ILLINOIS*	IL	6,613	33 PENNSYLVANIA	PA	7,561
12 INDIANA	IN	4,210	34 RHODE ISLAND*	RI	766
13 IOWA	IA	1,726	35 SOUTH CAROLINA*	SC	2,576
14 KANSAS	KS	1,888	36 SOUTH DAKOTA*	SD	483
15 KENTUCKY*	KY	2,820	37 TENNESSEE*	TN	5,414
16 LOUISIANA*	LA	2,776	38 TEXAS*	TX	17,409
17 MAINE	ME	857	39 UTAH	UT	1,487
18 MARYLAND*	MD	3,4605	40 VERMONT*	VT	316
19 MASSACHUSETTS	MA	3,708	41 VIRGINIA*	VA	3,305
20 MICHIGAN*	MI	7,652	42 WASHINGTON*	WA	6,006
21 MINNESOTA*	MN	4,904	43 WEST VIRGINIA*	WV	1,139
22 MISSISSIPPI*	MS	2,464	44 WISCONSIN*	WI	3,741
			45 WYOMING	WY	425

Source: John L. Mikesell, *State Tax Notes*, July 2004.

\*Asterisk denotes tax receipts were adjusted for comparability across states.

These data were calculated from Census sales tax revenue reports that do not fully follow the general definition of a retail sales tax. The sales-tax data were adjusted to permit reasonable comparisons across the 45 retail sales-tax states. Professor Mikesell calculated the sales tax reliance percentage as: ((adjusted sales tax revenue)/(total tax revenue)\*100.

These adjustments to sales tax revenue are described in Mikesell, *State Tax Notes*, February 3, 1997 and February 10, 2003. Examples of adjustments are:

1. Collections from the Washington business and occupation tax have been deleted.
2. Some transactions subject to sales tax in most states are exempt from tax but subject to special excises in a handful of states. These taxes have to be added to the reported sales tax totals to maintain equivalency across states.
3. Sales tax reports from Washington, Hawaii and Arizona include non-retail sales-tax elements. These revenues must be separated out for interstate comparability.
4. Reporting peculiarities require some adjustments such as the Louisiana Revenue Recovery District Sales tax and the New York City Metropolitan Transit Authority tax. The former has to be included and the latter has to be excluded.

## APPENDIX L: CALIFORNIA SALES AND USE TAX RATES

The statewide sales and use tax rate increased from 7.00 percent to 7.25 percent, effective January 1, 2002. On July 1, 2004, the components of the statewide 7.25 percent tax rate changed as a result of ABX5 9 (the California Fiscal Recovery Financing Act and the triple flip). The components of the statewide 7.25 percent sales and use tax rate are:

Current as of 7/1/03	Statewide 7.25% Sales and Use Tax Rate		Effective as of 7/1/04
Rate	Jurisdiction	Revenue & Tax Code	Rate
4.75%	State (General Fund)	6051, 6201	4.75%
	State (Fiscal Recovery Fund)	6051.2, 6201.2	.25%
.25%	State (General Fund)	6051.3, 6201.3	.25%
.50%	State (Local Revenue Fund)	6051.2, 6201.2	.50%
.50%	State (Local Public Safety Fund)	Sect.35 Art.XIII	.50%
6.00%	State Sales & Use Tax Rate		6.25%
1.25% (1.00% + .25%)	Local (County/City) Bradley Burns (City and county operations + County transportation funds)	7203.1	1.00% (.75% + .25%)
7.25%	Total Minimum Statewide Sales & Use Tax Rate		7.25%
Yes	Plus approved special jurisdiction & add-on rates		Yes
Source: Ca. Board of Equalization's web site: <a href="http://www.boe.ca.gov/news/sp111500att.htm">http://www.boe.ca.gov/news/sp111500att.htm</a>			

Components of the Statewide 7.25% Rate:\*

- *State Rate (6.25%)* - The largest single component is the 5.25 percent state General Fund rate. The Fiscal Recovery Fund part of the General Fund rate, 0.25 percent, will be used to repay up to \$15 million in bond sales to eliminate the state's 2002-03 General Fund budget deficit and address other obligations.<sup>†</sup> Also included in the overall state rate are two half-cent rates, which proceeds are respectively deposited into (1) the Local Revenue Fund, which supports health and social services program costs associated with the 1991 state-local realignment legislation; and (2) the Local Public Safety Fund, which was approved by the voters in 1993 for the support of local criminal justice activities.

\* This information updates the SUT rates described by the Legislative Analyst's Office, *The 2004-05 Budget: Perspectives and Issues*, pp. 53 and 56.

[http://www.lao.ca.gov/analysis\\_2004/2004\\_pandi/pandi\\_04.pdf](http://www.lao.ca.gov/analysis_2004/2004_pandi/pandi_04.pdf)

<sup>†</sup> This bond will be repaid through a multiple step process involving the diversion of \$0.25 of the Bradley-Burns local sales tax to the state Fiscal Recovery Fund. Local governments will then be reimbursed for their SUT losses through a shift in property taxes to them from schools, which in turn will be reimbursed through added General Fund payments to them. The diversion of SUT revenues will remain in effect until the bonds are paid off.

- *Uniform Local Rate (1.25%)* – This is a uniform local tax rate of 1.25 percent levied by all counties (the Bradley-Burns rate).
- *Optional Local Rates* - In addition to the statewide rate of 7.25 percent, many jurisdictions impose a local levy, which requires local voter approval.

In 2002 and 2003, the highest total sales tax rate, 8.75 percent, was in the City of Avalon, Los Angeles County, followed by San Francisco at 8.5 percent. Most jurisdictions charged 8.25 percent, 7.75 percent, or the statewide base of 7.25 percent. For cities, sales tax rates are posted at: <http://www.boe.ca.gov>.

It should be noted that for some purposes, the “state rate” is quoted as the General Fund Rate:

<b>Distribution of State Sales Tax Rates, January 1980 Through January 2004</b>					
	1/1/1980	1/1/1990	1/1/1995	1/1/2000	1/1/2004
California State Rate	4.75%	5%	6%	6%	6%
California General Fund Rate	4.75%	4.75%	5%	5%	5%
California’s state General Fund rate has changed several times over the past 30 years: Effective 4/1/74, there was a state rate of 4.75 percent; 7/15/91, a state rate of 5.5 percent; 7/1/93, a state rate of five percent; 1/1/01, a state rate of 4.75 percent; 1/1/02, a state rate of 5%; Source: California State Board of Equalization (BOE), 2003 Annual Report, Table 18, footnote d. <a href="http://www.boe.ca.gov/annual/table18_03.doc">http://www.boe.ca.gov/annual/table18_03.doc</a> . Effective 7/1/04, the GF rate was increased to 5.25 percent. Source: CA. BOE <a href="http://www.boe.ca.gov/news/sp111500att.htm">http://www.boe.ca.gov/news/sp111500att.htm</a> .					

**SUT rate for partial exemptions:** As a result of the changes in SUT rates effective 7/1/04, the statewide tax rate to be paid on goods that are partially exempt will decrease from 2.25 percent to 2.00 percent.

Current as of 7/1/03	Tax Rate to be Paid on “Partial Exemptions”		Effective as of 7/1/04
Rate	Jurisdiction	R & T Code	Rate
1.25%	Local (County/City)	7203.1	1.00%
(1.00% + .25%)	(City and county operations + County transportation funds)		(.75% + .25%)
.50%	State (Local Revenue Fund)	6051.2, 6201.2	.50%
.50%	State (Local Public Safety Fund)	Sect.35 Art.XIII	.50%
2.25%	Statewide Sales & Use Tax Rate to be Paid		2.00%
Yes	Plus approved special jurisdiction & add-on rates		Yes

Current as of 7/1/03	The Tax Rate Not Paid on “Partial Exemptions”		Effective as of 7/1/04
Rate	Jurisdiction	R & T Code	Rate
4.75%	State (General Fund)	6051, 6201	4.75%
	State (Fiscal Recovery Fund)	6051.2, 6201.2	.25%
.25%	State (General Fund)	6051.3, 6201.3	.25%
5.00%	Total Partial Exemptions		5.25%

## APPENDIX M: STATE AND LOCAL SALES TAX RATES

Comparison of State and Local Retail Sales Tax Rates			
(January 1, 2004)			
STATE	STATE SALES TAX RATE	Maximum Local Rate (1)	Maximum State/ Local Rate (1)
ALABAMA	4	7	11
ALASKA	none	7 (2)	7
ARIZONA	5.6	4.5	10.1
ARKANSAS	5.125	5.5	10.625
CALIFORNIA (3)	6	2.75	8.75
COLORADO	2.9	7	9.9
CONNECTICUT	6	---	6
DELAWARE	none	---	5.75
FLORIDA	6	1.5	7.5
GEORGIA	4	3	7
HAWAII	4	---	4
IDAHO	6	3	9
ILLINOIS	6.25	3	9.25
INDIANA (2)	6	---	6
IOWA	5	2	7
KANSAS (9)	5.3	3	8.3
KENTUCKY	6	---	6
LOUISIANA	4	6.25	10.25
MAINE	5	---	5
MARYLAND	5	---	5
MASSACHUSETTS	5	---	5
MICHIGAN	6	---	6
MINNESOTA	6.5	1	7.5
MISSISSIPPI	7	0.25	7.25
MISSOURI	4.225	4.5	8.725
MONTANA	none	---	---
NEBRASKA (10)	5.5	1.5	7
NEVADA	6.5	1	7.5
NEW HAMPSHIRE	none	---	---
NEW JERSEY	6	---	6
NEW MEXICO	5	2.25	7.25
NEW YORK	4.25	4.5	8.75
NORTH CAROLINA	4.5	3	7.5
NORTH DAKOTA	5	2.5	7.5
OHIO	6	2	8
OKLAHOMA	4.5	6	10.5
OREGON	none	---	---
PENNSYLVANIA	6	1	7
RHODE ISLAND	7	---	7
SOUTH CAROLINA	5	2	7

<b>Appendix M: Comparison of State and Local Retail Sales Tax Rates (continued)</b>			
<b>(January 1, 2004)</b>			
<b>STATE</b>	<b>State Sales Tax Rate</b>	<b>Maximum Local Rate (2)</b>	<b>Maximum State/Local Rate (2)</b>
SOUTH DAKOTA	4	2	6
TENNESSEE	7	2.75	9.75
TEXAS	6.25	2	8.25
UTAH	4.75	2.25	7
VERMONT	6	1	7
VIRGINIA	3.5	1	4.5
WASHINGTON	6.5	2.4	8.9
WEST VIRGINIA	6	---	6
WISCONSIN	5	1	6
WYOMING	4	2	6
DISTRICT OF COLUMBIA	5.75	---	5.75
Source: Federal of Tax Administrators, <a href="http://www.taxadmin.org/fta/rate/sl_sales.html">http://www.taxadmin.org/fta/rate/sl_sales.html</a>			

- 1) Highest local rate known to be actually levied by at least one jurisdiction. Includes local taxes for general purposes and those earmarked for specific purposes (e.g. transit). Taxes applying only to specified sales (e.g. lodging or meals) are excluded.
- 2) Alaskan cities and boroughs may levy local sales taxes from one to six percent.

## APPENDIX N: LEGAL BACKGROUND: THE 1992 *QUILL* DECISION

This summary of the legal background for the taxation of remote sales is from Due and Mikesell, *Sales Taxation*, 1994, pp. 252-254. An explanation of the due process and commerce clause of the U.S. Constitution is in Appendix O.

In 1965, the Alabama Supreme Court held that the mere mailing of catalogs to customers in the state did not establish nexus.\* In 1967, a second case arose in Illinois, out of that state's effort to enforce sales tax collection by National Bellas Hess, a mail-order house located in North Kansas City, Missouri. National Bellas Hess regularly mailed catalogs to Illinois residents and sold goods by mail, but had no place of business in Illinois. The company argued that the liabilities imposed upon it violated the Due Process Clause of the 14<sup>th</sup> Amendment and created an unconstitutional burden on interstate commerce. The Illinois Supreme Court upheld the state position that regular solicitation of business in the state by catalog constituted "doing business in the state" and gave the state the power to require collection and remittance of tax.†

Upon appeal to the U.S. Supreme Court, the decision of the Illinois Supreme Court was reversed by a six-to-three decision.‡ The U.S. Supreme Court stressed the difference between this case and previous ones in which the power of the state had been upheld; in the others, the vendor had retail outlets, agents or solicitors in the state (i.e. physical presence or nexus), whereas in this instance, the vendor merely communicated with the customer by mail or common carrier. To the majority of the U.S. Supreme Court, this difference was crucial and controlling. The opinion further said that were the power of Illinois to tax upheld in this instance, the vendor could be entangled "in a virtual welter of complicated obligations" to local jurisdictions, contrary to the intent of the Interstate Commerce Clause to ensure a national economy free of such interferences.

The dissenting opinion, written by Justice Abe Fortas, with the concurrence of Justices Hugo Black and William O. Douglas, took serious objection to the majority position, on the grounds that the large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market constituted adequate nexus to justify the requirement for collection of tax. Their opinion noted that National Bellas Hess enjoyed the facilities nurtured by the state of Illinois just as much as retailers located in the state and that failure to require the company to collect use tax penalized firms in the state subject to the tax. Although the opinion granted that payment of tax is not feasible on interstate sales of a casual, irregular nature, it noted that in this case solicitation was substantial, regular, pervasive and comprehensive. The burden placed on the National Bellas Hess would be no greater than that on a mail-order firm located within the state and not much more than that on any retailer.

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\* *State of Alabama v Lane Bryant*, 27 Ala. 385, 171 2d 91 (1965).

† *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 34 Ill. 2d 164, 214 NG 2d 755 (1867).

‡ *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967).

In the years following *National Bellas Hess*, mail-order sales grew exponentially, states were concerned with lost revenue because of the difficulty of enforcing the use tax against individual customers, and retailers complained of markets lost to tax-free competition. In the late 1980s, however, partly due to new Supreme Court Due Process and Commerce Clause jurisprudence (see *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)), and partly due to the advent of computer software developed to assist in the administration and collection of use taxes on remote sales, state legislatures began enacting statutory language that closely mirrored the language in the *National Bellas Hess* dissent. Departments of Revenue in a number of states began issuing assessments against mail order and catalog sellers engaged solely in the exploitation of a local market on a regular, continuous and systematic basis.

The test of constitutional principles came from a case in North Dakota. The Quill Corporation, a Delaware company with offices and warehouses in Illinois, California and Georgia, sold office equipment and supplies by mail advertisements in national periodicals and telephone calls, and made deliveries to North Dakota customers by mail or common carrier from out-of-state locations. Although Quill had no traditional physical presence, it was the sixth-largest office supply vendor in North Dakota. The state tried to make the economic presence of Quill sufficient to merit its registration and to require collection of use tax on deliveries into the state. In *Quill v North Dakota*, the U.S. Supreme Court partly overturned *National Bellas Hess* and partly sustained it, but North Dakota could not enforce its sales tax-requirement on Quill.\*

By holding that economic presence, rather than physical presence, is adequate to justify requiring collection of use taxes by out-of-state sellers, the Court thus in effect stated that Congress could give the power to the states to enforce payment from out-of-state sellers; if the Court had ruled that physical presence was necessary to meet the due process requirement, Congress would have been powerless to act to improve the ability of the states to enforce their use taxes, since Congress cannot override the due process clause. But in rejecting the state's argument that economic presence was adequate to enable the states to enforce collection of the use tax even though the firm lacked physical presence, states were denied the power to act against the out-of-state sellers unless Congress specifically gives them the power to do so. Thus the way is paved for Congressional action.

In *Quill*, the Supreme Court for the first time differentiated between the tests for determining whether a tax was constitutional under the due process clause or the commerce clause. The due process clause is concerned with fundamental fairness of governmental activity, and is premised upon whether a taxpayer has notice or fair warning that a tax may be imposed. The commerce clause, on the other hand, is concerned with whether a given tax unduly interferes with the free flow of interstate commerce. The appropriate nexus standard for due process was "minimum contacts" while the appropriate nexus standard for passing commerce clause muster was "substantial nexus." Further the Court noted that a mail-order house such as Quill may

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\* *Quill Corporation v. North Dakota*, 112 S. Ct. 1904, decided May 26, 1992.

indeed have the minimum contacts required for due process, yet lack the substantial nexus with the state required by the commerce clause.

Based on the distinction drawn in *National Bellas Hess* between mail order sellers with outlets, personnel or property in a state, and those with contacts limited to delivery via U.S. mail or common carrier, the Court found that *National Bellas Hess* had established a physical-presence requirement before a state can impose sales and use taxes under the commerce clause. The Court noted that such a bright-line rule was justified because it firmly established the boundaries of legitimate state authority in the area. The Court also noted that the underlying issue, collection of use taxes on remote sales, is not only one that Congress has the power to resolve, but is an issue that Congress may be better qualified to resolve. By separating the due process determination (where Congress does not have power to act) from the commerce clause standard, the Court effectively cleared the way for Congress to decide whether, when, and to what extent, the States may burden interstate mail-order concerns with a duty to collect use taxes.

## APPENDIX O: CONSTITUTIONAL ISSUES: DUE PROCESS AND THE COMMERCE CLAUSE

For an excellent discussion of Constitutional Restrictions on State Authority to Impose Sales and Use Taxes, see Appendix II, U.S. GAO report on Sales Taxes on e-Commerce, 2000.

Due process is mentioned twice in the U.S. Constitution; in the 5th Amendment\* (Trial and Punishment, Compensation for Takings) and the 14th Amendment† (Citizenship rights). The reference in the 5th Amendment applies only to the federal government and its courts and agencies. The reference in the 14th extends protection of due process to all state governments, agencies and courts.<sup>160</sup>

Due process, in the U.S. context, refers to how and why laws are enforced. It applies to all persons, citizen or alien, as well as to corporations.

- The “how” is procedural due process. Is a law too vague? Is it applied fairly to all? Does a law presume guilt? A vagrancy law might be declared too vague if the definition of a vagrant is not sufficiently detailed. A law that makes wife beating illegal but permits husband beating might be declared an unfair application. A law must be clear and fair and have a presumption of innocence to comply with procedural due process.
- The “why” is substantive due process. Even if an unreasonable law is passed and signed into law legally, substantive due process can make it unconstitutional.‡

Generally, due process guarantees the following (this list is not exhaustive):

- Right to a fair and public trial conducted in a competent manner,
- Right to be present at the trial,
- Right to an impartial jury,
- Right to be heard in one’s own defense,

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\* 5<sup>th</sup> Amendment: No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

† 14<sup>th</sup> Amendment: All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law, which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws... etc.

‡ For example, the Roe v Wade abortion decision declared a Texas law in violation of due process and ruled that in the first trimester, it is unreasonable for a state to interfere with a woman’s right to an abortion; during the second trimester, it is reasonable for a state to regulate abortion in the interest of the health of mothers; and in the third, the state has a reasonable interest in protecting the fetus. Another application has been to strike down legislation requiring certain non-dangerous mentally ill persons be confined against their will.

- Laws must be written so that a reasonable person can understand what is criminal behavior,
- Taxes may only be taken for public purposes,
- Property may be taken by the government only for public purposes, and
- Owners of taken property must be fairly compensated.

### *The Commerce Clause*

The U.S. Constitution, at Article I, Section 8, Clause 3, stipulates that Congress has the power to regulate interstate commerce. Specifically, the commerce clause says: “The Congress shall have power to... regulate commerce with foreign nations, and among the several states, and with the Indian tribes.” This constitutional provision has at least two important legal effects.

First, it provides a constitutional basis for much legislation that Congress passes. These laws may only indirectly involve “commerce” in the ordinary sense of the word. For instance, some civil rights laws of the 1960s were constitutionally justified on the ground that racial discrimination interfered with the free flow of persons and goods in interstate commerce, and that therefore Congress had a right, under the commerce clause, to pass non-discrimination laws. Since every federal law must have a constitutional basis in order to be valid, the commerce clause has been widely used as a constitutional base for federal legislation of every type.

Second, the commerce clause provides the courts with the power to invalidate state legislation that unduly interferes with interstate commerce, even if Congress has not acted in that area. Nearly 200 years ago, the Supreme Court decided that the mere absence of Congressional regulation did not signal that the states could do as they pleased. Instead, the Constitution has been construed to forbid state regulation that unduly interferes with interstate commerce, even though Congress has not spoken on the subject.

To borrow the rhetoric of free-trade advocates, the commerce clause allows the judiciary to protect the U.S. national market against the tyranny of local and parochial economic interests. This protection becomes more and more important as e-commerce grows and expands the scope of sales that have been made in the past by mail order

Since this second function is only relevant to the extent that Congress has not invoked its legislative powers under the commerce clause, it is often referred to as the “dormant” commerce clause, although in a literal sense, it is Congress, and not the Constitution, that is “dormant.”<sup>161</sup>

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